

**The Development of Relations Between Russia and
the European Union**

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Abstract of Thesis

Russians overwhelmingly see themselves as part of Europe, yet appreciate their Asian connection; there is a continuation of the 'Great Debate' between Westernizers and Slavophiles. Decades of official acrimony towards the EC were followed by acceptance of West European integration, if it did not involve Russia's isolation. After a period of *rapprochement* with Europe, a feeling of betrayal has recently grown in Russia. Nevertheless, the trend is for ever closer links with the West.

From the EU's perspective, Member States' conflicting views on the New Europe hinder a united approach to solutions. The EU has gained a very strong position with the collapse of the CMEA. The EU-Russia Partnership Agreement shows that vested interests of EU producers often prevail, yet useful structures for political dialogue were nonetheless created, and the prospect of a common free trade area is momentous. The need for a new security structure is unlikely to be satisfied by NATO's Partnership for Peace, but the EU has failed to lead European calls for a WEU or CSCE-based security framework.

The inheritance of the command economy has damaged foreign trade and investment conditions. Despite the transformation of the economy, much needs to be done to improve investment conditions for foreigners as well as for potential exporters — fiscal, export and property legislation must become workable, and the need to make a profit must be respected. Nonetheless, foreign investment projects are growing fast. The energy and aeronautics industries are used as case studies of the new possibilities for foreign investors and Russian exporters.

Having long been aimed at restricting Russian economic growth, statecraft has become an instrument of growth. The EU's assistance is particularly beneficial as it is non-reimbursable and aims at long-term change through training, yet TACIS could be improved by better management, smaller projects and lower wages. Overall, Western investment in Russian stability should increase.

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*À Maman et Papa:
sans votre soutien et votre amour,
je n'aurais pas été en mesure
de dédier quoi que ce soit.*

GLOSSARY

An-...	— Antonov (aircraft design bureau)
ATC	— Air traffic control
Be-...	— Beriev (aircraft design bureau)
bcm	— billion cubic metres
b/day	— barrels per day
BEE	— Business Eastern Europe
bnECU	— billion (a thousand million) ECU
CCP	— Common Commercial Policy (of the EC)
CFE	— Conventional armed Forces in Europe (disarmament treaty)
CFM	— Aeronautics joint venture between Snecma (France) and General Electric (USA)
CGIL	— Confederazione Generale Italiano di Lavoro
CIS	— Commonwealth of Independent States
CMEA	— Council for Mutual Economic Assistance (Comecon)
CoCom	— Coordinating Committee for Multilateral Export Controls
COREPER	— Committee of Permanent Representatives (to the EU)
CSBMs	— Confidence and Security Building Measures
CSCE	— Conference for Security and Cooperation in Europe
EC	— European Community (used in relation to foreign policy, from 1969 to the autumn of 1993)
ECSC	— European Coal and Steel Community
ECU	— European Currency Unit
EDC	— European Defence Community
EEC	— European Economic Community (used in relation to foreign policy, until 1969)
EES	— European Expertise Service
EFTA	— European Free Trade Agreement
EHRF	— European Human Rights Foundation
EIB	— European Investment Bank
EIU	— Economist Intelligence Unit
EMU	— European Monetary Union
EPC	— European Political Cooperation
EP Doc.	— European Parliament Document
EU	— European Union (used in relation to foreign policy, from

	the autumn of 1993)
Fadec	— Full authority digital electronic control
FAR	— Federal Aviation Requirement (USA)
Fishbed	— MiG-21 fighter jet
Flanker	— Su-27 fighter jet
Flogger	— MiG-27 fighter jet
Forger	— Iak-38 VTOL fighter jet
Foxhound	— MiG-31 fighter jet
Freestyle	— Iak-141 VTOL fighter jet
FRG	— Federal Republic of Germany
FTO	— Foreign Trade Organization
Fulcrum	— MiG-29 fighter jet
GATT	— General Agreement on Tariffs and Trade
GDR	— German Democratic Republic
GE	— General Electric (USA)
GKES	— State Committee for Economic Relations
GKI	— State Committee for Property (Goskomimushchestvo)
Gossnab	— State Supply Committee
GSP	— General System of Tariff Preferences
Hokum	— Ka-50 attack helicopter
IAI	— Israel Aircraft Industries
Iak-...	— Iakovlev (aircraft design bureau; often transliterated as Yak-...)
IBRD	— International Bank for Reconstruction and Development (otherwise known as the World Bank)
IECP	— International Energy Cooperation Programme
IFI	— International Financial Organization
Il-...	— Iliushin (aircraft design bureau)
IMEMO	— Institute of World Economy and International Affairs (Moscow)
IMEPI	— Institute of International Economic and Political Research (Moscow)
IMF	— International Monetary Fund
INF	— Intermediate-range Nuclear Forces (Treaty)
IRR	— Internal Rate of Return
JV	— Joint Venture
Ka-...	— Kamov (aircraft design bureau)
L/C	— Letter-of-Credit

MFA	— Multi-Fibre Agreement
mECU	— million ECU
MFN	— Most Favoured Nation
MICE	— Moscow Inter-bank Currency Exchange
Mintopenergo	— The (Russian) Ministry of Fuel and Energy
MMMMS	— An American-Japanese consortium consisting of Marathon Oil, McDermott Intl., Mitsui, Mitsubishi and Shell.
mt	— million tonnes
MVD	— Ministry of Internal Affairs
NACC	— North Atlantic Cooperation Council
NATO	— North Atlantic Treaty Organization
NGO	— Non-Governmental Organization
ODIHR	— Office of Democratic Institutions and Human Rights
OECD	— Organization for Economic Cooperation and Development
OPEC	— Organization of Petroleum-Exporting Countries
OPIC	— Overseas Private Investment Corporation (USA)
p.a.	— per annum
PA	— Production Association
P&W	— Pratt & Whitney (USA)
P&WC	— Pratt & Whitney of Canada
PCP	— Partnership and Cooperation Programme (under TACIS)
PHARE	— Poland/Hungary: Assistance for Restructuring Economies; later extended to cover the Czech & Slovak Republics, Bulgaria, Romania, Albania, Lithuania, Estonia, Latvia and Slovenia.
PMU	— Programme Managing Unit
QMV	— Qualified Majority Voting
QR	— Quantitative Restriction
R&D	— Research and Development
RAICD	— Russian Agency for International Cooperation and Development
RCB	— Russian Central Bank
REIO	— Regional Economic Integration clause (in negotiations over the European Energy Charter Basic Agreement)
RIIA	— Royal Institute of International Affairs

RPFB	— Russian Project Finance Bank
RR	— Rolls-Royce
Ruslan	— An-124 heavy-lift cargo aircraft
SALT	— Strategic Arms Limitation Treaty
SED	— Socialist Unity Party (East Germany)
SMEs	— Small and Medium-sized Enterprises
START	— Strategic Arms Reduction Talks
SWB	— The BBC's Summary of World Broadcasts
TA	— Technical Assistance
TACIS	— Technical Assistance to the CIS programme
TOR	— Terms of Reference
trnECU	— trillion (a million million) ECU
TsAGI	— Central Hydro and Air Dynamics Institute
TsIAM	— Central Institute of Aviation Materials
Tu-...	— Tupolev (aircraft design bureau)
UN ECE	— United Nations' Economic Commission for Europe
URVF	— Urals Regional Venture Fund
VIAM	— All-Russian Institute of Aviation Materials
Visegrad Four	— The Czech Republic, Hungary, Poland and Slovakia
VTOL	— Vertical Take-Off and Landing
WEU	— Western European Union
WTO	— Warsaw Treaty Organization

Introduction

Structure of the Thesis, and Significance of the Topic

Perhaps the best way to appreciate the importance of the transformation in relations between the USSR/Russia and the European Community/Union is to try to remember what the reaction would have been a decade ago to many of the achievements now realized. How would well-informed specialists have reacted to suggestions of a Partnership Agreement with Moscow; of a preferential trade regime for some Russian exports; of large-scale financing of projects for the enhancement of Russian technology; or the prospect of a common free-trade area? The velocity of change has been simply breathtaking. There is a great need for studies such as this to attempt to stay abreast of developments, whilst retaining some degree of historical perspective — not only to expand academic research in this field, but also to better equip the West European policy-makers who now have a chance to contribute to the success of true democratic reform in Russia.

Condensed into one sentence, the hypothesis defended by this thesis is that the *rapprochement* which has occurred between Russia and the EU — most especially during 1989 to 1992, although in many aspects still continuing at the end of 1994 and beyond — represents a greater degree of closeness and cooperation than has ever been achieved between Russians and West Europeans, and that a return to Cold War levels of isolationism and antagonism is virtually impossible. Clearly this has not been a smooth and monodirectional process; there are many forces both in Russia and in the EU which have opposed such a *sblizhenie*, and there have been many periods when these forces have been relatively stronger. In attempting to defend my position, I have tried nonetheless not to discard events and tendencies which have gone against the gradual

integration of Russia into European commercial and political developments. In the words of Hugh Miall, 'elements of a new order in Europe are visible, but not yet established, and elements of the old order are still in evidence. It is therefore unlikely that any single paradigm will be wholly satisfactory in a transitional period.'¹

It should also be mentioned at this stage that this thesis focuses primarily upon the period ending in 1994, although some gathering of additional material and re-writing continued until May 1996. The 'Postscriptum' is added to test the hypothesis suggested from the perspective available at the end of 1994, with the benefit of hindsight.

In order to understand the momentum for closer relations between Russia and the EU, it is essential to consider the debates among Russians on their role in Europe; such is the objective of the first chapter. This chapter seeks to demonstrate the following: (i) that the fact that the very optimistic period of strengthening relations between Russia and the EC/EU from 1986 to 1992 was followed by the disillusionment and relative discord of 1993-94 is not indicative of a definite and perpetual move away from Western Europe, but rather yet another cycle in the ongoing debate between Westernizers and Slavophiles; (ii) that despite this aspect of continuity, reforms within Russia and the increase in access to people, information and commodities from the EU have made a return to censorship and protectionism extremely unrealistic; (iii) that the Russian government has viewed relations with the EU at least as much as an opportunity to gain influence in a still developing European structure, as a threat of being isolated from the rest of Europe, this time with the CMEA countries on the opposite side; (iv) that Moscow's worries about security in Europe do not reduce the importance of relations with the EU, as the latter can assist in solving non-military aspects of security, and in creating a new role for the CSCE or an entirely new European security structure; and, in summary, that (v) what is most likely to prevail in

¹ Hugh Miall, *Shaping the New Europe*, RIIA, London, 1993, p. 19.

Russian policy towards the EU is a gradual but nevertheless increasing political and economic cooperation, rather than a definitive move away from the EU through the curtailing of trade, cultural and social ties.

The shift in Moscow's policies to the West in general is compared with the past record of Russian attitudes to Europe, concentrating on the post-1917 period. The elements of continuity are compared to the elements of change in Russian relations with Western Europe, to help predict how the relationship is likely to develop in the future. The focus then moves to the metamorphosis of Soviet policies towards the Community, and the reasons behind the relatively recent willingness to cooperate. The benefits which Moscow expects from cooperation with Brussels are detailed, both in terms of support for trade, and regarding the use of the European Communities as a way into the institutional framework of Western Europe. The degree to which Russian society has been Europeanized is addressed, as well as difficulties that would be involved in any attempt to curtail the availability of European goods, of European business partners, and even of an increasingly European approach to politics. Finally, this section examines the Russian perspective on the possible options for a new security structure for Europe, and the resulting concerns and fears in Moscow which Western countries cannot ignore if they want relations with the EU and other multilateral organizations to become closer, rather than give way to ever greater mutual suspicion.

This chapter should be a useful addition to the scarce literature on the background to Russia's contemporary policies towards Western Europe, whether in terms of politics, economics or security; in particular, it fills a lacuna concerning Russian expectations with regard to the economic benefits of reaching higher levels of interaction with the EU.

The factors driving the West European impetus for closer relations with Russia are elaborated upon in the second chapter. This chapter suggests that: (i) the consolidation and homogenization of EC policy towards the USSR, despite set-

backs and conflicting approaches amongst member states, together with the increasingly acknowledged need for the USSR to increase trade with the EC, meant that Brussels could largely dictate the terms upon which the two sides could agree to cooperate; (ii) although the EC/EU moved rapidly to approve the Trade and Cooperation Agreement, and included significant political aspects in the Partnership Agreement, the level of protectionism against Russian goods which was retained was unreasonably high, and bound to cause resentment in Russia; (iii) the prospect of establishing a free trade area between Russia and the EU — a possible consideration from 1998, according to the Partnership Agreement — is unfortunately very unlikely, as there are no reasons to believe that the EU member states are inclined to move sharply away from the protectionist attitudes which they have clearly shown thus far; (iv) the possibility for the EU to play an active and positive role in the development of a new security structure in Europe is unprecedented, on one hand because it can become involved directly in the increasingly important non-military aspects of security in Europe which affect Russia, and on the other hand by putting its political weight behind either increasing the role of the OSCE, or developing a new structure which could coordinate the peace-keeping and peace-enforcing activities of both Russia and EU states' armies, which is essential if Russia's feeling of frustration and isolation is to be reduced.

The influence of the varying and sometimes contradictory approaches of the Twelve to the EC/EU's *Ostpolitik* are considered, as are the effects of internal conflicts on overall EU policy towards Russia. This section further contemplates the reasons for the antagonism often evident when the West Europeans' relative inclination to cooperate has clashed with American policies towards Moscow. Also noted are Moscow's gradually more frequent and insistent requests to establish official relations with the EC, and Brussels' never hostile but always firm insistence that such an agreement would never accord the CMEA too much political influence, nor afford the USSR entirely free access to EC markets. Not only does this section go into detail of the December 1989 EC-

USSR Trade and Cooperation Agreement, but it is also one of very few detailed academic analyses of the negotiations for, and end result of, the June 1994 EU-Russia Partnership and Cooperation Agreement. The implications of existing security arrangements are explored, as are possible EU approaches to filling the current vacuum and facing the challenges of the next century, especially the possibility of closer cooperation with the OSCE.

The long term prospects of an Agreement can only be promising if that accord secures significant mutual benefits. In order to ascertain the prospects for greater economic interdependence to develop between Russia and the EU, the third chapter examines the extent of economic reforms, and their affect on trade with Western Europe as well as Western investment in Russia. This chapter intends to demonstrate that: (i) the USSR has always been disproportionately dependent upon trade with the EC, and that this dependence has increased even more since the dissolution of the USSR; (ii) pushed by the inability of the old Soviet economic system to keep up with the West's standards, Gorbachev de-monopolized foreign trade, made dealing with hard currency legal, started making the ruble more convertible, and initiated the privatization process, all of which were *sine qua nons* for large-scale non-state trading with the EC; (iii) although not improving the predictability of trading with Russia, El'tsin did achieve remarkable successes in the privatization of state enterprises, the full internal convertibility of the ruble, the possibility to repatriate profits, and the disappearance of a shortage economy; (iv) while the remaining disincentives to EU traders and investors are great — especially the political, legislative and fiscal complexity and changeability — trade with the EU has nevertheless gone from strength to strength, as have Western investments into Russia, and these are certain to expand exponentially if the above-mentioned risks are adequately reduced.

Starting with a brief section on the main aspects of a command economy which continues to affect Russian economic development to this day, the chapter

moves on to Gorbachev's economic *perestroika*, and finally concentrates on restructuring under El'tsin. The main subdivisions of these reforms — privatization; macrostabilization and price liberalization; and ruble convertibility — are all explored in terms of their affect on commercial dealings with the EU, and this is followed by a section on foreign trade policy, as well as foreign investment conditions. Clearly, the subjects discussed in this section are much too broad, not to mention volatile, to be covered in any great depth in the context of this topic, but they nevertheless form an essential part of this thesis.

Linked to this chapter are the two Appendices on the energy and aeronautics industries. Both of these promising spheres of Russia's economy are first examined in terms of their importance to Russia's foreign trade so far, and the prospects for that significance to increase. The potential benefits of greater cooperation with Western partners is then assessed, followed by some examples of foreign entrepreneurs who have already managed to become involved in these sectors, through joint production and/or trade. Documentation of the precedents set by these pioneers of commercial cooperation with the new Russia is crucial, to facilitate emulation by other entrepreneurs, whilst allowing them to avoid the pitfalls. The importance of the EU's own involvement in these industries, mostly through TACIS, is also discussed. These Appendices are based largely on primary sources, from entrepreneurs with first-hand experience of the intricacies involved in doing business with Russia.

The threat to the democratic reforms in the Former Soviet Union which is constituted by popular anger at material hardship and economic uncertainty is well recognized, as is the potential for Western assistance to reduce this threat, albeit in a limited manner. Chapter Four seeks to show that: (i) the aid being offered to Russia is a total reversal on previous Western policy towards Russia, and one of the rare tangible signs of the readiness of the EU and elsewhere to pay a price for more stability and prosperity in Russia; (ii) the assistance offered to Russia has been substantial, but often benefiting the Western providers at least as

much as the receivers, and not infrequently overpriced and inefficient; (iii) it is likely that the opportunity to appease public opinion through large-scale non-profit-orientated aid has now disappeared, as the level of cynicism and discontentment with reform and its Western supporters is now too high; (iv) despite its failings, EU and other assistance has had many positive effects, not only in terms of material support for new enterprise, but also in terms of setting good examples and offering the possibility to many of the most influential entrepreneurs to learn first-hand from Western businesses.

The very fact that such aid has been politically expedient in Western Europe demonstrates an acute change in the approach to statecraft, although this section also considers the continuing debate between those who see aid as a necessary tool for reform, and those who think it should be a reward for effective restructuring. The evolving influence of the EU's statecraft towards Russia is what this section concentrates on, especially the use of food grants, credits, and technical assistance. The complicated and world-leading contribution of the EU's technical assistance to the CIS (TACIS) is explored here in more depth than any other available academic work, as the author considers its role to be potentially vital, if its effect can be maximized. It is stressed that the type of assistance offered by TACIS cannot be expanded to yield its full results in the short term, as the knock-on effect of those trained by the EU will take time to be felt. The mechanisms for coordination of Western assistance are discussed, as is the increasing degree of joint action between the EU, the European Bank for Reconstruction and Development, and the World Bank Group. Finally, this thesis also examines the possibility and desirability of an expansion of EU assistance to Russia.

Methodology and Sources

As mentioned at the beginning of this introduction, this thesis supports one overall direction, namely that Russia and Western Europe are, gradually and not without important set-backs, becoming more integrated with time. In terms of traditional international relations theory, this integrationalist position is situated neither at the cynical extreme of Realist thought, nor at the opposing utopian pole of orthodox Functionalist thinkers.

The schools of Realism (followed by neo-Realism, and sometimes called the Strategist school), and Functionalism (followed by neo-Functionalism and then post neo-Functionalism, and closely related to institutionalism) were developed from an analysis of international relations based largely on the work of Martin Wight. Wight based his theories concerning the dynamics of international relations on the debate between three groups of thinkers: the Machiavellians, the Grotians and the Kantians, which were sometimes referred to as respectively the Realists, the Rationalists and the Revolutionists. Crudely, Wight saw them thus: the Machiavellians were 'the blood and iron and immorality men', the Grotians 'law and order and keep your word men', and the Kantians 'subversion, liberation and missionary men'.² Hedley Bull stated that Wight had overemphasized the importance of the debate between the three traditions, believing that much of what has happened in history cannot be covered by any of the three schools of thought, and that Wight's strong assumption that there has to be a pattern in the development of thought on international relations was not always substantiated.³ Yet Wight himself had written that these three traditions were merely paradigms, to which no actual thinker did more than approximate, adding that 'in all political and historical studies the purpose of building pigeon-holes is to reassure oneself that the raw material does not fit into them'.⁴

² Hedley Bull, 'Martin Wight and the Theory of International Relations' in *International Theory — the Three Traditions*, eds Gabrielle Wight and Brian Porter, London, 1991, p. xi.

³ *Ibid.*, p. xviii.

⁴ Martin Wight, 'Conclusion — the Balance of the Three Traditions' in *International Theory — the Three Traditions*, eds Gabrielle Wight and Brian Porter, London, 1991, p. 259.

In the more contemporary argument between Realists and Functionalists, the former tend to believe that the increase of state power, which occurs in a relatively 'anarchical environment' with no effective authority existing to limit this power, 'will always be the immediate aim of nations'. Die-hard Realists believe that states do not trust each other, and that they will be more interested in relative than absolute gains, thus hampering collective action. According to this view, 'states will only establish an alliance under the circumstances of an acute external threat or other powerful external pressures'. They stress the inevitability of discord among nations, and the temporary nature of alliances.⁵

Functionalists, on the other hand, typically see intrinsic value in cooperation, believing that it is vital in an increasingly interdependent world. One very important principle within Functionalism is the 'spill-over' concept. This can be divided into 'functional spill-over' and 'political spill-over'. The former reflects the belief that as one sector of a state's economy is integrated with others, pressures mount for sectors related to the integrated one to also become integrated, and so on. As more sectors are integrated, there is also overall pressure for the dissolution of tariffs, for convertible or even common currencies, and therefore for compatible monetary policies. Political spill-over relates to the expected increase in pressure for integration as various sectors of society become accustomed to interacting, and to dealing with the multinational centre, in both cases coming to realize the benefits of the multinational approach.⁶

Thus it is clear that the position taken in this thesis is much more akin to Functionalism than to Realism. However, the above descriptions of these schools of thought are merely caricatures, descriptions of two extreme positions. Exploring the extent to which Functionalist or Realist theories apply to all the real-life policies and actions which are described in this thesis, and indeed suggesting how these schools of international relations theory should themselves be changing in view of the restructuring of the role of multinational organizations

⁵ Peter van Ham, *The EC, Eastern Europe and European Unity*, London, 1993, p. 6.

⁶ Stephen George, *Politics and Policy in the European Community*, Oxford, 1988 (reprint), pp. 21-23.

in Europe, would be of great interest, but is beyond the scope of this already wide-ranging thesis. The terms Functionalist and Realist will only be used in one context in this thesis, in order to simplify the explanation of the approach to statecraft (in Chapter Four) towards Russia by certain policy-makers, to differentiate between the varying expectations from assistance.

An inevitable problem with a thesis so broad in scope is limiting the areas which are covered, even though they could justifiably be included. For Chapter One, spending more time scouring various Russian sources for the changing impressions of Russia's role in Europe was an unaffordable luxury, as was the tempting prospect of designing and carrying out a small poll of Russian opinion on the matter. The second chapter could unfortunately only give a glimpse of the direction in which the EU could encourage the development of a new security structure, with the military aspects of security being granted only very superficial consideration. Chapter Three, on Russian economic reform and its implications for relations with the EU, could never hope to be anything more than a background chapter, the topics therein warranting at least a dozen doctorates by themselves. In the final chapter, the Bretton Woods institutions could regrettably only be discussed with regard to how the aims of their assistance compared with those of the EU, even though detailed analysis of their projects would also have been relevant. Other areas in which Brussels is not directly involved, notably investment guarantee funds and Russian foreign debt relief, would all have been closely related to the subject matter. In all these areas, detailed and up-to-date studies would be very useful, and would complement this thesis well.

Of the sources used in the first chapter, two authors have been of particular influence. Peter van Ham's *The EC, Eastern Europe and European Unity* was a particularly reliable source of information, but most of all this first section has much in common with the work of Neil Malcolm. Malcolm's 1989 *Soviet Policy Perspectives on Western Europe* was an important source in the early stages of research, and the draft chapter 'New Thinking and the Politics of Soviet European

Policy', discussed at the RIIA in July 1991, was also of much influence. Perhaps not surprisingly, considering this common background, many of the same conclusions were reached in this thesis and in *Russia and Europe — an End to Confrontation?*⁷ My indebtedness to Neil Malcolm is gratefully acknowledged, although I would like to indicate that many common findings — in particular seeing the recent debate on Russia's role in Europe as a continuation of the 'Great Debate', and the belief that the Eurasians' less positive attitude towards the West did not mean an end to Europeanization — were reached independently, before *Russia and Europe* was released.

For the chapter on Brussels' attitude towards Russia, it must be admitted that van Ham's *The EC, Eastern Europe and European Unity*⁸ was again a most useful source of reference. Perdita Fraser's work was also particularly useful, for both the second and fourth chapters, providing an insightful perspective on some of the Community's attitudes towards Moscow.⁹ For Chapter Three, Leonard Geron's *Soviet Foreign Economic Policy Under Perestroika*¹⁰ was the most comprehensive yet concise source on Gorbachev's economic reforms, whilst Alan Smith's *Russia and the World Economy — Problems of Integration*¹¹ was a particularly useful tool for the analysis of Russia's own efforts to improve investment and export conditions. In the final chapter, Peter van Ham yet again deserves mention as an influential informant for the section on statecraft, this time with his *Western Doctrines on East-West Trade*;¹² most of all, the passage on statecraft benefited from Philip Hanson's *Western Economic Statecraft in East-West Relations*.¹³

⁷ Neil Malcolm (ed.), *Russia and Europe — an End to Confrontation?*, London, 1994(i); also of influence was Neil Malcolm, 'The New Russian Foreign Policy', *The World Today*, February 1994(ii), pp. 28-32.

⁸ Peter van Ham, 1993, op. cit.

⁹ Perdita Fraser, *The Post-Soviet States and the European Community*, London, 1992; and 'Russia, the CIS and the European Community: Building a Relationship' in *Russia and Europe — an End to Confrontation?*, ed. Neil Malcolm, London, pp. 199-223.

¹⁰ Leonard Geron, *Soviet Foreign Economic Policy under Perestroika*, London, 1990.

¹¹ Alan Smith, *Russia and the World Economy — Problems of Integration*, London, 1993.

¹² Peter van Ham, *Western Doctrines on East-West Trade*, London, 1992.

¹³ Philip Hanson, *Western Economic Statecraft in East-West Relations*, London, 1988.

For the most interesting and innovative parts of this work, however, well-established academic sources have been scarce. Apart from certain EC/EU documents which have comprehensively and directly covered some of the issues tackled herein (such as the Partnership Agreement, or TACIS Action Programmes), the data have mainly come in small fragments, from very varied sources. Some journals have provided penetrating and relevant articles; from the Russian side, *MEMO* (Mirovaia ekonomika i mezhdunarodnye otnosheniia) and *Mezhdunarodnaia zhizn'* (and its English translation, *International Affairs*) were the most dependable, whilst the *NATO Review*, *Soviet Studies/Europe-Asia Studies* and *International Affairs* (London) were among the most useful Western journals. Many topics and events in the thesis were too recent to have been included in the academic journals, yet were approached in bulletins or reports, the *RFE/RL Research Reports* providing insightful articles, whilst the very broad scope of *Business Eastern Europe* was of unparalleled assistance for the update of the section on foreign trade and investment. Many other facts were only to be found in newspapers, with *The Guardian* and *The Financial Times* being most reliable in London, and *Kommersant*'', *Nezavisimaia gazeta* and *The Moscow Times* being the preferred titles from Moscow. Occasional use has also been made of news releases from news agency wires, for which the author is indebted to journalist friends in Moscow.

As concerns primary sources, most of the documents used here were accessed from one of four information centres. Many European Community documents were obtained from the European Communities Delegation in Moscow, and others were accessible at the London School of Economics' European Documentation Centre. Many documents from the IMF, IBRD and EBRD, as well as EC/EU materials, were available at the Department of Trade and Industry's World Aid Section. The author also benefited from access to presentations and meetings with Russian politicians both at the School of Slavonic and East European Studies (SSEES), and the Royal Institute of International Affairs (RIIA). Also very informative were the Chatham House

discussion groups for the various chapters in Neil Malcolm's *Russia and Europe*, which the author had the opportunity to attend. Much useful information was also acquired through participation in conferences on legal cooperation between the EC and the USSR, on foreign investment in Russian oil and gas, as well as in the aeronautics industry. Work carried out by the author on TACIS project analysis and design, under the guidance of John Pilgrim of Pilgrim Associates, offered a different and incisive perspective on the workings of EU assistance.

The vast majority of written material used for this thesis was gathered in the period up to December 1994, after which the author was working in the Urals. Although this has meant that the re-writing and updating of the thesis could not include as many new published materials as could perhaps have been the case, the author's position as Regional Representative for the Flemings Urals Regional Venture Fund, established by the EBRD, has afforded a unique opportunity to benefit from the perspective of very many enterprise managers and public administrators in the Sverdlovsk, Perm and Cheliabinsk *oblast's*.

Chapter 1: The Russian Vision of Europe

1.1 Introduction

This chapter begins by examining the dynamics of relations between Russia and Western Europe, especially since the Second World War. After looking at the history of ups and downs in relations between the USSR/Russia and the West, the author questions whether the very rapid improvement and fruitfulness of relations between Moscow and Brussels at the turn of the 1980s, and the subsequent cooling of that interaction, are unique. Russian views on and relations with the European Community under Gorbachev, the first Soviet leader to allow an official relationship to develop, are then explored in more detail. How the Soviets approach to the EU changed, and most importantly why it altered, is what must primarily be determined. Similarly under Gorbachev's successor, the ebbs and flows of both academic opinions and official policy on relations with the West, together with underlying motives, are closely examined.

The focus of the following section is Moscow's reaction to European integration throughout the second half of this century, underlining the dramatic improvement which has occurred in the last decade. Section 1.4 further examines what has qualitatively and probably irreversibly changed in relations with Western Europe, in a context not only of foreign policy, but also everyday attitudes and freedoms. Quieter and often disregarded forces supporting reforms are examined. Section 1.5 briefly depicts the distinct relations which Moscow has with Bonn, and how they have affected Russia's readiness to continue striving for close relations with the EC/EU.

Finally, the changing security situation from Moscow's viewpoint is explored. The evolving nature of security concerns is addressed, as is the importance of the reduced perceived military threat to Russia, most of all because

of improved relations with the USA, which are therefore also summarized. The need Moscow sees for a new security structure in Europe, and the options available for such an organization, then follow. The author concludes the chapter with the main findings from every section, and an overall judgement on whether or not relations between Russia and the EU can expect to remain relatively close, or whether they are destined to be re-frozen in the mould of the Cold War.

1.2 Russia's Role in Europe — the Endless Cycles of the Great Debate

The ambivalence of Russia's attitude towards Europe is as old as Russia itself. It can be argued that the debate started in the mid-fifteenth century, when Metropolitan Isidore returned from the Ferrara-Florentine Council of 1439, with news that he and all but one of the other Orthodox patriarchs had signed a declaration of unity. Isidore ended up fleeing from a Muscovy which largely retorted that it would rather be ruled by the Turks than by the Roman Pope.¹ The Grand Duke of Muscovy arrested Isidore in 1441, thus emancipating the Russian Metropolitan from Constantinople. Yet when Constantinople fell to the Turks in 1453, there were some who expressed regret, believing that as part of Christendom, Muscovy should have defended Christendom as a whole, whilst the official church-state stance was that the Russian Church was now the only true, unadulterated and living faith. The Polish-Lithuanian invasion of the early seventeenth century also created a modest group of pre-Westernizers; a minority of Russians, rather than criticize the invaders' non-Orthodox nature, lauded their economic and political organization. It was this minority which attempted to make Wladyslaw of Poland tsar of all Russians.²

This duality became much more significant with Peter the Great's attempts to Westernize everything from Russia's fashion to its armed forces, but it was

¹ Nicolas Zernov, *Eastern Christendom: a Study of the Origin and Development of the Eastern Orthodox Church*, London, 1961, pp. 126-29.

² Iver B. Neumann, *Russia and the Idea of Europe*, London, 1996, pp. 5-10.

only in the nineteenth century that it was to be clearly and academically deliberated. This so-called 'Great Debate' between the 'Slavophiles' and the 'Westernizers' started in earnest in 1836 with Petr Chaadaev's 'First Letter', and attracted most attention during the following three decades. On the one hand there were the Westernizers, who wanted to see a much greater presence of European influences in Russia, whether it be European art, fashion, philosophy or industry, and on the other hand the Slavophiles, who detested Western materialism and traditionally saw the value of Russia in the Russian Orthodox Church, the 'Russian soul' and its special links with 'Mother Russia', as well as in the role of the *mir* (council of elders) and the *obshchina* (commune). This dichotomy, and the resulting conflicts, remain to this day.

It has been suggested that the adoption of Marxism as the governing ideology in Russia should have given the Westernizers the decisive upper hand.³ Theoretical Marxism, seeking to really transfer power to the people, and aiming to eventually eradicate the need for government, was certainly more democratic than tsarist Russia. Even Lenin's long-term revolutionary plans were originally Western-orientated. Karen Dawisha wrote that Russia was seen by Lenin as 'an important home-base, safe-haven, hide out, and arms cache all rolled into one for the European revolution'.⁴ Maksim Gorkii went so far as to write in 1918 that 'the Smolny government treats the Russian worker like brushwood — it kindles the brushwood in order to see: will a European revolution be ignited by the Russian bonfire?'⁵ Yet even in terms of relations with the Western powers, Lenin remained fairly conciliatory; the need for a *peredyshka* (breathing space) was a common post-revolutionary theme. Vladimir Il'ich aimed not only at increased foreign trade, but also at encouraging Western business concessions in Russia, as extra insurance against war.⁶ With the advent of the New Economic Policy, links

³ Karen Dawisha, 'Soviet Ideology and Western Europe' in *Soviet Strategy Toward Western Europe*, eds E. Moreton and G. Segal, London, 1984, p. 21.

⁴ *Ibid.*, p. 22.

⁵ Maksim Gorkii, 'Untimely Thoughts', (from *Novaia zhizn'*, 5 January [18 January OS] 1918) New York, 1968.

⁶ Margot Light, *The Soviet Theory of International Relations*, Brighton, 1988, pp. 26-29.

with the West became particularly important, economic interdependence having again (at least temporarily) been accepted. As long as Lenin was in power, the Kremlin kept one eye to the West, whether for trade revenues, or in the hope of exporting the revolution.

With Stalin's accession to power came a return to the old autocratic ways of the tsars, which had been made easier by Lenin's own lack of respect for democracy, such as the dissolution of the first Constituent Assembly, and the harsh repression of opposition. The new 'tsar', who came to be famed for his paranoia and persecution complex, saw only enmity in the West. He was extremely un-European — he extolled the exclusive virtues of Russia, he denigrated the consumerism and corruption not only of the European bourgeoisie, but also of its proletariat, and pursued the ideology of 'socialism in one country'. There are innumerable accounts of how damaging Stalin's intolerance towards Western ways was for Russia's industrial, cultural and intellectual life. Under Stalin, in the words of the Soviet historian Konstantin F. Shteppa, there developed 'a new Slavophilism negating Western influence, extolling Chernyshevskii, Lenin and Stalin at the expense of Marx himself'. In his article 'On the article of Engels "The External Policy of Russian Tsarism"' (1949), Stalin even criticizes Engels for condemning Russian foreign policy under the tsar!⁷ Marxism was retained in name, but in essence Stalin's policies steadily distanced themselves from Marx's ideas. Although Stalin still echoed the term 'Peaceful Coexistence' first used by Lenin, and continued to maintain workable relationships with some 'imperialist' powers, his approach was much more cynical. The level of the Soviet dictator's anti-Westernism was shown by his readiness to side with the Nazi dictator against the major part of Western Europe. After unsuccessful attempts to cooperate with Britain and France in face of the Nazi threat, Stalin settled for the Soviet-Nazi pact — hardly appropriate for 'peaceful coexistence'. Although acknowledging some dependence upon foreign trade, Stalin closed down all Russian subsidiaries of Western firms. Under Stalin, cohabitation with the capitalists was presented

⁷ Karen Dawisha, *op. cit.*, pp. 14-15.

more aggressively, more as a result of Western weakness and fear of the USSR.⁸ Only in the last years of Stalin's power was there a slight increase in emphasis on cooperation rather than mere coexistence, starting a trend of better relations with the West, which Khrushchev was to continue.

It would clearly be an exaggeration to call this shift a return to Westernism, however — a sizeable amount of Bolshevik hostility towards the whole of the Western world, including Europe, still remained. Nevertheless, Western Europe came to be seen in a relatively more favourable light. Stalin's extreme anti-Westernism was being replaced by a more flexible approach. The increased risk of war, and most of all the devastating effect on the Russian economy of having curtailed trade and technological interaction with the West to next to nothing, swung the Kremlin back into a more moderate position. What changed with Khrushchev was that the references to Peaceful Coexistence became increasingly frequent, and stark. According to Margot Light, Peaceful Coexistence 'was no longer a tactic or even a strategy, but had become, with proletarian internationalism, the principle on which Soviet foreign policy was based'. Khrushchev also specified that Peaceful Coexistence was more than the absence of war — it was the renunciation of war as a method of settling international disputes.⁹ Brezhnev's bid for power was even more closely associated with détente, and he only achieved a strong majority in the Politburo and Central Committee after convincing Party ideologues that more openness to the West would not damage socialism domestically.¹⁰ Although using the term Peaceful Coexistence less often, he achieved more concrete results than Khrushchev in his first decade in power. The proof that the cycle had continued towards increasingly pro-Western policies came with the signing of the SALT agreement in 1972, and the Helsinki Final Act in 1975; there was also an unprecedented readiness for cooperation in research and ecology with Western

⁸ Margot Light, *op. cit.*, pp. 37-39.

⁹ Margot Light, *op. cit.*, pp. 45-50.

¹⁰ Peter Shearman, 'Soviet Foreign Policy, 1917-1991' in *Russian Foreign Policy Since 1990*, ed. Peter Shearman, Boulder, 1995(i), p. 17.

countries during the early 1970s.¹¹ This relative détente was fragile, however — its economic rewards had been very limited; it had not prevented the hostile ‘twin track’ approach of NATO to INF negotiations (whereby the Atlantic Alliance started preparations for the deployment of cruise and Pershing 2 missiles in Europe, which could be stopped only by the removal of Soviet SS-20 missiles aimed at Western Europe), nor the reluctance of the US Senate to ratify SALT II; and the Helsinki Final Act had encouraged a troublesome increase in dissident activity in Eastern Europe. It has also been argued that a greater emphasis on the ideological struggle with the capitalist world had emerged in reaction to the growth of the convergence theory in the West.¹² Economically, by the late 1970s the West had much less credit to offer the Eastern Bloc in the aftermath of the OPEC crises, and the high level of indebtedness of some of the CMEA states.¹³ It is important to stress that this period of détente did not result in any significant access to Western goods, a much freer flow of information or new possibilities of entrepreneurship for the population as a whole. There was no reason, other than political, for popular opposition to a new Cold War.

Thus the Kremlin allowed itself, once more, to paint the Western powers’ actions in as dark a hue as possible, and became more willing to risk a re-freezing of relations with the West.¹⁴ This break-down in détente was an important factor in Moscow’s decision to intervene in Afghanistan, triggering a period of even greater hostility with the West. As we shall examine later, both the Soviet Union and many West European countries managed to continue forging some links despite the renewed political hostilities between the superpowers in the early 1980s, but nevertheless, the undercurrent of East-West relations in the late 1970s was flowing back towards the isolationism and antagonism of the Slavophiles.

¹¹ Henry Kissinger, ‘Kissinger on Détente’ in *Major Problems in American Foreign Policy*, ed. Thomas G. Patterson, Lexington, Massachusetts, 1989, p. 632.

¹² Margot Light, *op. cit.*, p. 61.

¹³ Marie Lavigne, *Economie internationale des pays socialistes*, Paris, 1985, p. 52.

¹⁴ Peter J. S. Duncan, ‘Soviet Policy Towards the Main West European Powers’ in *Gorbachev and Europe*, eds V. Harle and J. Iivonen, London, 1990, p. 88.

Already by the end of Brezhnev's leadership, though, there were signs of a new shift westwards, as Andropov's influence in the Politburo increased. Yet again, the isolationist and relatively anti-Western outlook of the previous years, and the negative effect on the economy and on the likeliness of armed conflict with the West, resulted in a return to more cooperative dealings with Western Europe and its Atlantic partners. The new positive overtures towards the West included the March 1982 moratorium on the deployment of SS-20s, and the 'no-first-use' policy on nuclear weapons later announced by Brezhnev. In December 1982, Andropov offered a reduction in the number of Europe-orientated SS-20s equal to any quantitative decrease in British and French missiles, if deployment of cruise and Pershing missiles was cancelled (this initiative was rejected by the Western powers).

In other words, by the time Gorbachev came to power, there were already a few precedents of a more cooperative approach, of a less antagonistic perspective. However, the new General Secretary was to ensure that this pro-Western wave became much more all-embracing, and better publicized. Gorbachev was to put himself firmly in the Westernizers' camp by talking about 'We Europeans'.¹⁵ Soon after Mikhail Sergeevich came to power, the Soviets went back to START and INF negotiations. In August 1985 Gorbachev declared a moratorium on nuclear testing, which lasted seventeen months; it was not copied by Washington, but it did win Gorbachev much public support in the West. In April 1986, Gorbachev again showed his awareness of West European fears of Soviet conventional superiority, as he brought forward proposals for the reduction of conventional forces from the Atlantic to the Urals.¹⁶ On the nuclear front, Moscow conceded to 'asymmetrical reductions', and the historic elimination of all land-based nuclear missiles with a range of 500-5,000 km, followed by the agreement to include shorter range missiles. The demilitarization of Europe continued further in December 1988, when Gorbachev announced a

¹⁵ Ole Waever, 'Three Competing Europes: German, French, Russian', *International Affairs*, London, no. 3, 1990, p. 482.

¹⁶ Peter J. S. Duncan, *op. cit.*, pp. 89-94.

500,000 troop reduction in Eastern Europe.¹⁷ By the summer of 1990, the USSR had agreed with every East European country (except with Poland, where there had been disagreements about the necessary time-span) on a timetable for the complete withdrawal of Soviet troops from what used to be its satellite states. From late 1986, Moscow also changed its approach to the UN, putting much more emphasis on the conflict resolution aspects, rather than defensively using this body for collective security only; in other words, the UN was now seen as an instrument of conflict resolution, not just a mechanism to avoid intervention.¹⁸ This was most clearly shown in the USSR's support of UN intervention in the Gulf War, and subsequent blue-helmet interventions, notably in the former Yugoslavia and Somalia.

Gorbachev's foreign policy was also shown to be uniquely 'westernized' through his endeavour to find solutions to non-military global problems. Admittedly, already in 1976 Brezhnev had talked about global problems at the Twenty-Fifth Party Congress, but no breakthroughs followed. Gorbachev declared at the Moscow Peace Forum in 1987 that

Our world is united not only by the internationalization of economic life and by powerful information and communications media, but also in facing the common danger of nuclear death, ecological catastrophe and global explosion of the contradictions between its poor and wealthy regions.¹⁹

This statement was backed by a readiness on the part of the Soviets to develop nuclear safety together with Western experts, as well as enthusiastic participation in conferences and debates on other ecological issues. According to Shenfield, Soviet 'globalistics' started spreading in the early 1970s, but were to be legitimized only in the early 1980s. Global problems have had a variety of definitions, from being exclusively those problems which constitute a clear threat

¹⁷ Neil Malcolm, *Soviet Policy Perspectives on Western Europe*, London, 1989, p. 2.

¹⁸ Robert Boardman, *Post-Socialist World Orders — Russia, China and the UN System*, New York, 1994, pp. 89-94.

¹⁹ Stephen Shenfield, *The Nuclear Predicament: Explorations in Soviet Ideology*, RIIA, London, 1987, p. 60; taken from *Moscow News*, no. 8, 1987, p. 3 of the supplement.

to human survival, to covering almost any problem which might benefit from an international attempt at alleviation. Gorbachev's definition of global problems, as presented in a speech in Prague in April 1987, was rather broad, including AIDS, terrorism, crime, drug addiction, underdevelopment, pollution and the threat of war.²⁰ The new priority accorded to these areas of concern has affected Moscow's approach to security, as discussed later in this chapter and in Chapter Two. This new 'global' approach to foreign policy was symbolic of the greater importance attached to the effect of policies on the world at large; Eduard Shevardnadze (then Soviet Foreign Minister) openly stressed the need 'to correlate public opinion (in the West) with the foreign policy actions planned (by the USSR)'.²¹ Clearly, this swing towards the Westernizers' pole of foreign policy went much further than during any other period of Soviet government, and had irreversible implications.

The change both in the perception of Western Europe and of its relation to Russia, and in the approach to information and censorship, became irrefutable. There was a gradual but overwhelming tendency in Soviet specialist writing, from 1985 until the beginning of the 1990s, to emphasize the high levels of cooperation and understanding between the peoples of both sides of Europe. One commentator stressed Europe's common cultural heritage, and realization of the horrors of war, from the raids of Attila's Huns to the devastation of the Second World War.²² The historians Iu. Borko and B. Orlov pointed out that from the end of the seventeenth century, Russia started actively participating in many aspects of European life. Both these historians agreed that after decades of self-isolation, the Soviet Union was left with catching-up to do, both materially and morally. In their opinion, isolation during the Renaissance and Reformation periods may have been at the root of the violence and intolerance of Soviet mass

²⁰ Stephen Shenfield, *op. cit.*, p. 63.

²¹ Gerhard Wettig, *Changes in Soviet Policy Towards the West*, London, 1991, p. 16.

²² A. Grigoryants, 'Europe — Our Common Home', *International Affairs*, Moscow, no. 4, 1986, p. 81.

culture in the 1980s.²³ It was regularly stated that the Soviets share with Western Europe a particular attachment to détente, due to their similar geographical situation and experience of war.

At least until the end of the 1980s, opinions on foreign policy included in academic journals such as *MEMO* and *New Times* could be expected to have support in at least part of the Central Committee, or else high up in MID. Although strongly pro-Western and anti-isolationist articles did not necessarily reflect the view of the relevant decision-makers, they did show the dichotomy which was by then present within the various foreign policy-determining organs of Soviet government. Writing for the sake of truth and academic debate did not start until the turn of the 1980s, at least in such established journals; until then, the views therein were bound to be shared by some influential cadres. A more diverse array of opinions was being printed in the second half of the 1980s, often offering contradictory opinions and suggestions, because this reflected the clash of opinions which reigned in foreign policy-determining bodies. The mere fact that conflicting information could be published reflected Gorbachev's readiness to widen the debate on foreign policy. This put the Foreign Ministry in a relatively strong position, where it could use its greater knowledge and expertise. At the same time, the Central Committee's International Department became less influential.²⁴ This change in itself made Soviet foreign policy decision-making more similar to the equivalent process in Western Europe, and more influenced by Westernizing tendencies. It would be wrong to say that unanimity had always reigned in the higher echelons of Soviet power in the past; struggles had often taken place. As Peter Shearman explains,

Leadership in the USSR was personalized, and in order to build authority and power individuals needed to formulate programs

²³ Iu. Borko and B. Orlov (dialogue), 'Chto nam stoit obshcheevropeiskii dom postroit', *MEMO*, no. 1, 1990, pp. 50-51.

²⁴ Neil Malcolm, 'Russian Foreign Policy Decision-Making' in *Russian Foreign Policy Since 1990*, ed. Peter Shearman, Boulder, 1995, p. 25.

identified with themselves that would appeal to a winning coalition in the Politburo and Central Committee of the CPSU.²⁵

The difference now was that the debate, in fact the lobbying process itself, was made more open to the public. This was to be even more the case in the 1990s.

Turning back to the intellectuals in the last years of the Soviet era, the predominating opinion was that the artificial barriers between East and West served no useful purpose, and that it was time to stop seeing Europe as divided between socialism and capitalism. According to Orlov, the Soviets had not reached socialism or even come close to its high levels of morality and humanism, whilst the West had gone past capitalism, its working class no longer being exploited, its democracy no longer serving only the middle classes, and it having now developed an 'embryonic' level of social justice.²⁶ Also reducing the divide between the two sides of Europe was a willingness by the Soviet Union to acknowledge its diminished international political status. This new-found modesty was prompted by the belief that to appear threatening was simply no longer affordable, not only because of the amount of resources having to be poured into the military sector, but also because of the lost trading opportunities. The head of IMEMO's (the Institute of the World Economy and International Relations) West European Department wrote that Moscow hoped to fulfill its new primary aim in foreign policy, which was to integrate itself more tightly into the international community, by going through the 'European window'. This could only be possible if Europe did not feel threatened by the Soviet Union.²⁷

Such concern to reduce West European apprehension about the Soviet Union was clearly echoed by Gorbachev's government, and represented a vital development in Soviet European policy; previously, argued Adam Ulam and Hannes Adomeit, even when Moscow was trying to achieve friendlier terms with the West Europeans, there was still a tendency to resort to threats regarding the

²⁵ Peter Shearman, 1995(i), op. cit., p. 17.

²⁶ Iu. Borko and B. Orlov, op. cit., p. 56.

²⁷ Vladimir Georgievich Baranovskii, 'Evropa: formirovanie novoi mezhdunarodno-politicheskoi sistemy', *MEMO*, no. 9, 1990, p. 9.

consequences of non-cooperation.²⁸ The Kremlin under Gorbachev instead swallowed its pride and sought a smooth, friendly relationship with Europe.

An important aspect of this new perception of the relationship with Western Europe was the much-talked-about 'Common European Home'. This concept was very nebulous, however, and understood in various ways by various people at different times. This is a predictable problem, partly because, as Orlov and Borko point out, the notion of 'home' has different meanings to different nationalities, be it a tent, a mud hut, an old wooden cottage or a gigantic concrete apartment bloc. This may help to explain why attempts to find all-embracing definitions became rather vague, for example: 'Home is a place where you are understood, and you understand others, where residents show an interest in each other, and where an atmosphere of accord and spirituality surrounds them';²⁹ or Deputy Foreign Minister Vladimir Petrovskii declaring that the establishment of a Common European Home would support Kantian principles of international relations, 'discarding stereotypes of disunity as it shapes a new system of human relations on the principles of non-violence, solidarity and cooperation'.³⁰ Although the concept of the Common Home was included in the majority of articles on relations with Europe in the late 1980s, there were few attempts made to clarify what institutions and/or measures the Soviets would have liked to see holding this home together.

It is not without reason that the concept of a 'Common European Home' came to be heard less and less; although it was initially a major component in Gorbachev's new approach to Western Europe, the subjectivity of the term, and the discord over what the new home should or could look like, eroded the support for this slogan for a new Europe. Alex Pravda has suggested that the need for constant shifts in the Common Home ideal stemmed from the fact that the Common European Home was conceived as some sort of scaffolding, bridging the

²⁸ See for example Adam Ulam, 'Europe in Soviet Eyes', *Problems of Communism*, May-June 1983, p. 29.

²⁹ Iu. Borko and B. Orlov, op. cit., p. 49.

³⁰ Neil Malcolm, 1994(i), op. cit., p. 160; taken from *International Affairs*, Moscow, March 1991.

Western and Eastern blocs; with the collapse of the WTO, it was simply left hanging.³¹ By 1990 Russians seldom talked of Europe as a 'home', largely because no two architects had the same plans, but perhaps also because the hope of transcontinental domestic bliss had faded.

After five years in office, Gorbachev was far from his early days of unchallenged leadership and traditional respect for the General Secretary — his opponents were numerous, and vehement. Starting in earnest in 1989, as it became clear that Moscow was to lose control of Eastern Europe as a result of New Political Thinking, Gorbachev's opposition went from strength to strength. By the summer of 1991, the Chairman of the KGB was implying that Gorbachev was helping Western intelligence services in their plans 'for the pacification, and even occupation, of the Soviet Union under the pretext of establishing international control over its nuclear potential'.³² Soon afterwards, a group including a deputy defence minister and the Deputy Interior Minister publicly questioned how it happened 'that we put in power those who do not love this country, who enslave themselves to foreign patrons and seek advice and blessing across the seas?'³³ After a period where the Foreign Ministry's vision of foreign policy went relatively unchallenged, in 1990-91 the KGB and the armed forces were pushing for alternative approaches to relations with the West.³⁴

Yet despite this harsh high-level criticism, which pushed Mikhail Sergeevich to take certain conciliatory actions and appear somewhat less modest and desperate in his appeals to the Western community, the basic direction of his foreign policy remained unchanged. Gorbachev still hoped to be included in, and supported by, the G7; he also met the then President of the European Commission, Jacques Delors, in the summer of 1991, and showed a continued desire to have closer links with the EC. No serious alternative to total

³¹ Alex Pravda, 'Soviet Foreign Policy Priorities Under Gorbachev: Europe and Beyond', unpublished draft paper, presented to the RIIA, May 1991.

³² *The Guardian*, 24 June 1991.

³³ *The Guardian*, 24 July 1991; the deputy ministers involved were General Valentin Varennikov and General Boris Gromov — their appeal was published in *Sovetskaiia Rossiia*.

³⁴ Neil Malcolm, 1995, op. cit., p. 25.

cooperation and interdependence with the West had been put forward by Gorbachev's entourage or the Soviet Ministry of Foreign Affairs as long as they were in power.

The transformation of Russia's perception and approach to Western Europe under Gorbachev should be seen as more than just another high in a constant cycle of relatively pro- and anti-Western policies; the level of cooperation with Western countries and inter-governmental organizations was truly unprecedented, and the openness to Western information and commodities made a return to previous levels of isolation and censorship extremely unlikely.

With the failure of the conservative *putsch* in August 1991, El'tsin's rise to power and the dissolution of the USSR, the tide of Westernism reached its highest mark. As great as Gorbachev's need had been to reappoint a large proportion of senior government and party cadres, and to seek the support of the intelligentsia and the media, if he was to succeed in his revolutionary endeavours, the necessity for El'tsin to do this was yet greater, if he was to succeed in the dismemberment of the Union and the dismantling of the Communist Party. The support of the West was seen as equally essential, not only to ensure that Russia would be in a 'no-threat' situation during those times of instability and weakness, but also in the hope that the more radical economic reforms planned could be made to succeed. In the early days of the new Russian government El'tsin fully supported his Foreign Minister Andrei Kozyrev, for example when the latter stated at a foreign policy conference in February 1992 that 'the main guideline is to achieve inherent compatibility with the world economy, in particular by joining the IMF and other institutions at an early date', adding that Russia intended to continue along the road 'leading from a cautious partnership to friendly and eventually allied relations with the civilized world, including NATO, the UN, and other structures'.³⁵ In fact, for the first time, the Foreign Ministry became the only body left to determine Russia's foreign policy, apart from the President's own

³⁵ Andrei Kozyrev, speech at the Conference on Foreign Policy and Diplomacy at the Foreign Ministry of the Russian Federation (26-27 February 1992), *International Affairs*, Moscow, April-May 1992, pp. 86-90.

apparatus. The KGB was being reformed, a separate Minister of Defence was only found (in Pavel Grachev) in May 1992, and the International Department had disappeared with the rest of the CPSU.³⁶

Both the President's and MID's positions were, in fact, arguably overly pro-Western. Not because they ceased to be guided by Russia's national interests, as has sometimes been suggested. Moscow has never ignored Russia's self-interest — it had simply very dearly valued a high level of trust and cooperation with the West. Once this trust and cooperation was seen to have delivered only limited financial and security rewards, and once it became less vital as the President's position became consolidated in domestic political terms, the value of unconditional support to the West was reconsidered. The definition of national interests at that stage was changed back to a position that was more reminiscent of pre-*perestroika* times, but by no means as strongly isolationist and antagonistic. The problem was that the Russian leadership had joined most of Russian society in overestimating what the West would do to help.

It was, clearly, unrealistic of Russia to expect aid on the scale of the Marshall Plan (as explained further in Chapter Four), or to suddenly see all trade barriers with the European Community disappear; however, it should not be seen as unreasonable. Russia's expectations must be seen in context. After the dissolution of the Communist Party's monopoly over politics, the freeing of information and communications, the collapse of the WTO and Comecon, widespread statements on new peace and cooperation, there was little reason to disbelieve that *anything* was possible. In the West also, many had heightened hopes for the future of cooperation with Russia. We have already noted Mitterrand's plan for a Confederation of Europe; on the economic side, even Michel Camdessus, Managing Director of the International Monetary Fund (IMF), said at the Lisbon Conference (May 23-24, 1992) that the international community will have to find over \$30bn per year to save the reforms in the

³⁶ Neil Malcolm, 1995, op. cit., p. 33.

FSU.³⁷ In other words, Russia was not alone in overestimating what the West was ready to do to build a new Europe with Moscow's full participation. Russia was fully entitled to high hopes.

The reaction to the realization that both financial assistance and support in the international forums would be much less than originally hoped was, of course, very negative. Andrei Kozyrev declared himself

worried by how quickly a 'school of thought' has sprung up in the West which maintains that it is better to have dealings with a weakened Russia, left alone with its troubles. How Russia and its problems can be isolated is not explained. However, this 'selling short' of a power which is historically destined to be great is not only unrealistic but dangerous [...]³⁸

Already by the February 1992 conference, therefore, there were clear signs of strong pressure to make policies towards the West less 'artificial' and 'idealistic'. For example Vladimir Lukin, the Chairman of the Russian Supreme Soviet's Committee on International Affairs, stressed that although there was some important common ground with Europe, Russia should approach it realistically 'because it has interests of its own and is a scene of great changes. Entering the scene there are new powerful forces of a traditional nature that have both serious reasons to help us and very serious reasons not to strengthen us'.³⁹ What was to become 'New Realism', as it has been called by Neil Malcolm, had roots dating to Soviet days; the historian Mikhail Aleksandrov wrote in early 1991, for instance, that the concept of New Political Thinking was just as nebulous and idealistic as that of proletarian internationalism, adding that 'it is known, from the experience of history, that attempts to implement any ideology on a global scale have always ended in failure'.⁴⁰ Even Andrei Kozyrev had

³⁷ *The Guardian*, 25 May 1992.

³⁸ Andrei Kozyrev, 'The New Russia and the Atlantic Alliance', *NATO Review*, February 1993, p. 4.

³⁹ Vladimir Lukin, 'A Transformed Russia in a New World', at the Conference on Foreign Policy and Diplomacy (see note 35), op. cit., p. 93.

⁴⁰ Mikhail Aleksandrov, 'Mify i real'nosti "bol'shoi" ideologii', *Literaturnaia Rossiia*, no. 1, 4 January 1991, p. 5.

denounced the 'utopianism' of Shevardnadze's foreign policy in 1991,⁴¹ and in February 1992 complained that the New Political Thinking reaction to the Cold War 'gave way to another extreme that made us see all countries through rose-coloured spectacles...'.⁴² Opposition to the pro-Western stance was building up in numbers partly because forces opposed to the splitting-up of the USSR had begun to regroup, through the new Russian Ministry of Defence and the new Russian successor to the KGB, the FSK (Federal Counter-espionage Service), and on a broader scale through the Russian Communist Party and the Liberal Democratic Party.

By late 1992, overwhelming pressure had built up against the policy of total reliance on the West and international organizations, for reasons examined further on in this chapter. The result was that the massive swing to pro-Western policies by the USSR and then Russia, having lasted barely more than half a decade, was already reversing into a gradually more independent and antagonistic phase.

The battle between Westernizers and Slavophiles acquired not only 'new' names, but new positions; the prevailing debates came to be between schools known as 'Atlanticist' (or Euro-Atlanticist⁴³) and 'Eurasianist' (or neo-Eurasianist⁴⁴). As with the 'New Realist' or other movements, however, any attempts to clearly define the period of prevalence of Atlanticism or Eurasianism is somewhat artificial. Already in early 1991, a senior advisor to El'tsin noted the predominance of two main tendencies 'in the mentality of the peoples and authorities of Russia' — European and Asian.⁴⁵ Another contributor to early neo-Eurasianism stated that a greater orientation towards Asia would be natural, and

⁴¹ Neil Malcolm, 1994(i), op. cit., p. 164.

⁴² Andrei Kozyrev, speech at the Conference on Foreign Policy and Diplomacy (see note 35), op. cit., p. 85.

⁴³ A term suggested by Mohiaddin Mesbahi, in 'Russian Foreign Policy and Security in Central Asia and the Caucasus', *Central Asian Survey*, vol. 12, no. 2, 1993, p. 182.

⁴⁴ Ibid.

⁴⁵ Galina Starovoitova, 'Poimet li Rossiia Evropa?', *Demokraticheskaiia Rossiia*, no. 6, 26 April 1991, p. 10.

indeed that the process had already started, as shown by the negotiations already then under way towards the establishment of a Black Sea Council, and by closer contacts with China, Korea and Japan.⁴⁶ Nonetheless, the 1990-91 period was still dominated by the remnants of New Political Thinking and the consequent New Realism, and it is only in 1992 that Eurasianism started to be of real impact.

The changeability of the supporters of these various schools of thought is likewise too often overlooked. Pleasingly tangible names of prevailing ideologies suggest that they have their devoted followers who are sworn enemies to the challenging movements, but in fact experts and politicians have been regularly transferring allegiances. Sergei Stankevich, Russian State Counsellor on Political Affairs, is an example of someone who was extremely pro-Western in the late 1980s, but who had become a leading light of the Eurasianists by 1992. Perhaps the best example is the Foreign Minister himself, who has at various times been labelled as both 'New Realist'⁴⁷ and 'Atlanticist',⁴⁸ and has since 1993 shown clear signs of certain 'Eurasianist' tendencies. It is helpful to remind ourselves of the fluidity of the situation, and that these name-tags are only approximate indications of main tendencies in attitudes to foreign policy.

The term 'Atlanticism' was in many ways a continuation of the New Political Thinking, synthesized with New Realism. It is, of course, not to be confused with the Atlanticism discussed previously by Soviet scholars, which referred to the tendency for close links to be maintained between North America and Europe. Russian Atlanticists tended to view the Western powers not as adversaries, but potential partners in a new world order.⁴⁹ Part of that new world order was often perceived by them as including a Westernization of the Asian parts of the FSU, through the influence of 'an enlightened Russian big brother'.⁵⁰

⁴⁶ Vladimir Ivanitskii, 'S Evropei ili s Aziei?', *Dialog*, no. 10, July 1991, p. 80.

⁴⁷ Neil Malcolm, 1994(i), op. cit., p. 161.

⁴⁸ Alexander Rahr, "Atlanticists" versus "Eurasians" in Russian Foreign Policy', *RFE/RL Research Report*, vol. 1, no. 22, 29 May 1992, p. 19.

⁴⁹ *Ibid.*, p. 18.

⁵⁰ Mohiaddin Mesbahi, op. cit., p. 183, quoting Evgenii Gusarov's article in *Rossiiskaia Gazeta*, 5 March 1992.

Nonetheless, it was European Russia which was the main concern, as it not only housed the majority of the population, but also of infrastructure, factories and so on. In other words, it was European Russia that had the greatest chance of making reforms work in the shortest possible time.⁵¹ The success of economic reforms was the key to the Atlanticists' reasoning — foreign policy was seen as subordinate to this goal. This school also called for a rejection of imperialism, and a renunciation of any ideological basis to external affairs.⁵²

Eurasianism was not a new concept. It first emerged under that name in the aftermath of the First World War and of the Russian revolutions, supported by scholars such as Trubetskoi⁵³ and Savitskii. The Eurasian movement at the beginning of the century was much more anti-European than its contemporary namesake (in its mainstream form), and was also vehemently opposed to Western colonialism. The original Eurasianists explicitly stated that they were the followers of the Slavophiles and pan-Slavs.⁵⁴

The main core of neo-Eurasianists in the early 1990s was more moderate and open-minded to Western influence than were traditional Slavophiles. Many Eurasianists wanted to maintain good relations with the West, mostly for technology and know-how.⁵⁵ They generally acknowledged the decreased role of the military in establishing the international power hierarchy, and the increased significance of the economic sphere.⁵⁶ This at least was the line of the more influential Eurasianists — Stankevich, Ruslan Khasbulatov, Aleksandr Rutskoi, former Secretary of the Security Council Iurii Skokov, and increasingly, Kozyrev. This is admittedly a broad definition of Eurasianism, but it does still have at core a desire to increase Russia's independence from the West, seeking to compensate by increasing influence and interaction with neighbours to the East and South.

⁵¹ Andrei Zagorskii, 'Russia and Europe', *International Affairs*, Moscow, January 1993, p. 50.

⁵² Alexander Rahr, 1992, op. cit., p. 18.

⁵³ Sergei Stankevich, 'A Transformed Russia in a New World', at the Conference on Foreign Policy and Diplomacy (see note 35), op. cit., p. 99.

⁵⁴ Mark Bassin, 'Russia Between Europe and Asia: the Ideological Construction of Geographical Space', *Slavic Review*, vol. 50, no. 1, 1991, pp. 13-14.

⁵⁵ Alexander Rahr, 1992, op. cit., p. 20.

⁵⁶ Mohiaddin Mesbahi, op. cit., p. 187.

Yet even this relatively moderate core of Eurasianism clashed in many ways with previous Russian policy. The increasing coverage of their standpoint, and most importantly the prominent positions held by the above-mentioned politicians, clearly reflected a shift not only in academic debate, but in the position of the most crucial foreign policy decision-making bodies. Very slowly, the tide was retreating from the Westernizers' shore.

One of the earlier objectives of this group was to encourage closer relations with the non-European republics of the FSU, whilst criticizing the inordinate amount of attention and resources given to relations not only with the USA and Western Europe, but even with Ukraine.⁵⁷ As El'tsin's original attempt to create a Slavic Union (with Ukraine, Belarus', even Poland and Bulgaria) failed, it became easier to steer policy in this direction. The next main Eurasianist target was policy towards the West. Although friendly relations were still sought, the common stance was that there was too much emphasis on the need to conform to Western expectations. By relying totally on Western ways and norms, Russia would suffer greatly from her lower level of economic development; Stankevich warned that 'for quite a few years to come, we will have to settle for the role of junior partner'. In any case, he stressed that Russia has been geopolitically distanced from Europe by the establishment of new independent states between Russia and Europe, which created a need for the 'redistribution of our resources, potentialities, ties and interests in favour of Asia and the Eastern sector'.⁵⁸ Like the Eurasianists of old, the contemporary movement started emphasizing a particular Eurasian characteristic of Russia; both Stankevich and Vladimir Lukin stress the historic mixture of Orthodoxy and Islam and the 'traditional Turkic-Slavic unity'.⁵⁹ This inextricable Asian side of Russia, and the close relations it has held with many Asian powers, are behind the calls for the Russian government not to align itself fully with the West, in opposition to

⁵⁷ Alexander Rahr, 1992, *op. cit.*, p. 20.

⁵⁸ Sergei Stankevich, at the Conference on Foreign Policy and Diplomacy (see note 35), *op. cit.*, pp. 100-01.

⁵⁹ Vladimir Lukin, at the Conference on Foreign Policy and Diplomacy (see note 35), *op. cit.*, p. 92.

Islam. There were fears that Russian pressure to enforce Western standards of human rights and liberal democracy, and talk of a 'Northern' military alliance between Russia and NATO, could alienate the Muslim world and China, and perhaps precipitate a North-South conflict, which would be much more damaging to Russia than to the West.⁶⁰ Eurasianists saw Russia's role as that of a bridge between Western and Eastern civilizations,⁶¹ a unique player in global relations as it can claim to be a part of each.

Eurasianists claimed to support reform, but with a much greater degree of central control. In any case, they saw foreign policy not as an extension of domestic policy, 'but as an equally important pole of an interdependent dynamic'.⁶² The intrinsic role of foreign policy was greater than that perceived by the Atlanticists. There was a renewed desire to show Russia's power and maximize her influence; in the words of Evgenii Primakov, then head of Russia's Foreign Intelligence Service, relations with China, India, Japan and the Third World are as important as those with the West,

because Russia cannot be great, it cannot play the positive role it is destined to in the absence of such wide geopolitical scope. In promoting relations with all other countries, we must remember that history never nullifies geopolitical values.⁶³

In simplified form, this is a struggle between those who still thought in terms of Moscow's strategic interests being served by geopolitical strength, and those who saw the health of the Russian economy, and a long-term elevation in material standards, as worthy of sacrifices in geopolitical control.⁶⁴

On the opposite side of the political spectrum from the Atlanticists were chauvinist-populists under many banners — the 'Red-Brown' alliance, 'National Patriots', and more recently 'Liberal Democrats'. The relative position of these

⁶⁰ Alexander Rahr, 1992, *op. cit.*, p. 19.

⁶¹ Andrei Zagorskii, *op. cit.*, p. 48.

⁶² Mohiaddin Mesbahi, *op. cit.*, p. 186.

⁶³ Evgenii Primakov (Foreign Minister, at the time of printing), 'A Transformed Russia in a New World', at the Conference on Foreign Policy and Diplomacy (see note 35), *op. cit.*, p. 96.

⁶⁴ Neil Malcolm, 1994(ii), *op. cit.*, p. 31.

two poles is closer to the original Great Debate. Like last century's Slavophiles, these groups 'reject the increased use of markets, the spread of private property, the opening up of the economy to foreign investment and the export of Russian mineral wealth'.⁶⁵ The selling of Russian raw materials to foreigners is a particularly emotional issue, with articles seeking to increase resentment by blaming the ecological destruction in Russia on foreign demand for natural resources, or being particularly outraged at the exporting of Russian black earth (the violation of Mother Russia not stated, but implied).⁶⁶ These are relatively moderate examples, compared to some of the xenophobic and anti-semitic statements published in the extreme-right newspaper *Den'*, and a whole myriad of lesser newspapers and leaflets being energetically distributed by supporters of neo-fascist policies. Although the activists, and even strong supporters of the more strongly anti-Western doctrines, seem to represent only a minority of the population,⁶⁷ the frustration caused by the present poverty and chaos (and other factors, examined further on in this chapter) are widespread, and with it the inclination to seek easy solutions and gratification. This was shown clearly in the December 1993 elections, when Vladimir Zhirinovskii obtained a significant proportion of votes (23% of votes on the party list, assuring his Liberal Democrats a significant role in the State Duma). These elections also underlined the extent to which El'tsin must now take account of public discontent, if he is to minimize this protest vote in his own Presidential elections.

This, again, was a first. Public discontent with the political situation, including the foreign policy of the existing government, could now result in the government having to change its policies, if not be replaced altogether. The

⁶⁵ Pekka Sutela, *Economic Thought and Economic Reform in the Soviet Union*, Cambridge, 1991, p. 155.

⁶⁶ Mikhail Lemeshev, 'Spasaetsia li zapad razrusheniem Rossii', *Moskva*, February 1993, pp. 119-20.

⁶⁷ According to a poll conducted by the All-Russia Centre for Public Opinion and Market Research (VTsIOM), only 5.7% of those questioned fully trusted Zhirinovskii, whilst 50.2% did not trust him at all; this compared to 16.7% who fully trusted El'tsin (Iavlinskii topping the poll with 18.3%), whilst 23.1% had no trust at all in the President (that figure being 12.5% for Iavlinskii) — in *Moscow News*, no. 7, 18-24 February 1994, p. 3.

coming to power of the Liberal Democrats would be particularly disastrous to relations with the EU and the West in general. In 1993, the Liberal Democrats of Russia were blaming the opening of borders and the squandering of resources for the poor material standard of living of many Russians, and called for a cessation of all 'soliciting' of credits from the West.⁶⁸ The Communists were not exhibiting this sort of xenophobia in their pre-election campaign, but it nevertheless seemed clear that the CPRF's call for the establishment of a foreign policy which would 'respond to Russia's national interests and guarantee its safety'⁶⁹ was intended to be interpreted in a manner very much less pro-Western than that of El'tsin's team and Foreign Ministry.

Thus the balance of official policy shifted slightly towards the neo-Slavophiles, with El'tsin's government putting more effort into relations with Asian countries (with the exception of Japan, as the Kurile Islands will remain a problem under Eurasian-influenced policies), and tightening up the CIS. It is no coincidence that 1993 saw the re-inclusion of Azerbaijan, and even enough pressure to make Georgia join the Commonwealth. The enlargement and greater integration of the CIS became a more important objective, and Russian control of its periphery a stated goal (see 'The Security Dimension of the New Europe', below). Russia's insistence on the right to intervene in neighbouring states with peace-making missions is just one example of Moscow's new forcefulness in foreign policy; other clear signs included the anti-interventionist stance on the Bosnian war, the pressure to ease sanctions against Iraq, and intervention in diplomatic conflicts in the Middle East and North Korea. This by no means equated to a total shift to anti-Western policies by El'tsin's government; closer cooperation with the West was still a clear aim, including joining GATT, developing closer relations with the EU, and even becoming part of a 'G8'. Most of the shifts of foreign policy were towards the 'Near Abroad', and seemed to

⁶⁸ Vladimir Zhirinovskii, *Programma Liberal'no-Demokraticheskoi partii Rossii, Ustav LDPR*, pamphlet, Moscow, 1993, pp. 1-2.

⁶⁹ *Pravda Rossii*, no. 6, 9 December 1993, from the CPRF's 'call to the electorate'; also echoed in electoral publicity supporting a CPRF candidate for the State Duma.

have reluctant agreement from Western governments. This was possible, despite the overwhelming opposition to pro-Western policies in the State Duma, due to the relative independence of MID, and most of all because the President and his team have ultimate control in any case. On the other hand, the momentum increased towards greater isolation and antagonism, supported by domestic fear and strain. Even by early 1996, this tendency had not been reversed, although neither had it greatly increased in strength.

1.3 Overall Shift Westwards

Having examined the cyclical nature of Russian foreign policy thinking, and the shift away from an unambiguously pro-European approach since 1992, it might be reasonable to expect the pendulum to move back all the way to the level of anti-Europeanism of Brezhnev, or even Stalin. Yet this thesis argues that this will not be the case. Both Russia and the rest of the world have changed enormously since the days of the old Communists, and there is much to suggest that the parameters of the Great Debate have shifted Westwards.

The very fact that for almost a decade Russians have now been able to contemplate being a part of Europe is very important. The feeling of 'Europeanness' is compounded by an exponential increase in contact with the West since 1985; for a majority of people, this includes articles in Russian newspapers and journals, Western music, Western consumer goods available in kiosks and shops, and perhaps most of all, Western programmes on Russian television (including BBC news); for a large and powerful minority, there are also personal contacts with Westerners in Russia, and foreign travel. One of the great achievements of Communism, the high level of education of the Russian people, has made it much less likely that most Russians could be duped into not arguing intelligently and forcefully for the continuation and development of desires and dreams they have now experienced. The precedent of *glasnost*'s freedom of

expression is also a vital factor here. There is more to communications than television (including foreign satellite television) and newspapers, of course: the immense number of telephones, faxes, networked personal computers with printers all make it virtually impossible to prevent contacts with Europe, and the distribution of knowledge thus acquired. Wide-ranging and well-publicized debate on all issues, including foreign policy, can no longer be halted.

The diffusion on a global scale of this communications revolution has led to new heights of economic interdependence amongst nations. Russia's dependence is all the greater for the loss of control over Eastern Europe, and largely over the FSU states as well. Attempts at self-reliance would mean not only greater material hardship and public discontent, but also a free-fall into even lower levels of relative technological development. The domestic effect of economic reforms is also easy to underestimate. Despite the many setbacks to the reform programmes, an independent business sector has developed, consisting of both new entrepreneurs and managers of state enterprises which have now been privatized. Regardless of their backgrounds or politics, most of these businessmen have a vested interest in maintaining a free and strong economy, with the foreign trade that that entails. This private sector is constantly expanding, and many experts argue that privatization has long reached the point of no return⁷⁰ (see Chapter Three).

Neil Malcolm has pointed out that the very style of political debate has taken on a more Western flavour. Already we often take for granted the massive change in the ideological basis of foreign policy (even if it was often no more than a front) brought about by Gorbachev and Shevardnadze, by abandoning the need to couch ideas in Marxist-Leninist ideology. Gone also is the nineteenth-century black-and-white battle of two extremes; instead, the most influential supporters of both tendencies are now rather centrist, agreeing on many issues. An unprecedented degree of mutual influence and compromise has also had to

⁷⁰ For example Richard Layard (economic advisor to the Russian government), 'Can Russia Make It?', lecture given at the London School of Economics and Political Science, University of London, 8 February 1994.

develop between various organs of the legislative and executive authorities. Perhaps the best indication of this is the 'Russian Federation Foreign Policy Concept', adopted in the spring of 1993; this was a clear attempt to minimize the differences between the Foreign Ministry, the Ministry of Defence, the military and Parliament. Increasingly, Russian foreign policy was becoming a 'compromise between pragmatically conceived longer-term interests and the shorter-term interests of influential groups',⁷¹ in other words, much more similar to what Western democracies are used to. As has been noted by Westernizers in the past, the very passion with which Russia either attempted to imitate Europe, or to reject and slander it, was a sign of its non-Europeanness; the recent tendency to concentrate less on theories and more on real problems and interests indicates that Russian statesmen may have become more comparable with the statesmen of the West,⁷² for better or for worse.

The source of the most visible and audible objections to the Westernist tendencies of Gorbachev and El'tsin should be looked at more closely. The vast majority comprises pensioners and other low-income groups who have little to offer to a market economy and do not have the support of a well-founded social security service. Although the pensioners are powerfully represented in elections, turning out at polling stations in much greater numbers than Russian youth, their influence stops there. The only strongly anti-reformist sector of the population which has tangible power is the military. The possibility of a military take-over is something which El'tsin must be concerned about, and which explains best of all his readiness to shift away from the Westernist pole of foreign policy. Yet the likelihood of such a turn of events is very small, unless the President attempts to maintain power against *both* the results of Presidential elections and the desire of the military leaders.

Much of the support for reforms, or at least the opposition to a return to isolationism and centralism, is largely silent yet strong. This includes the many

⁷¹ Neil Malcolm, 1994(ii), op. cit., p. 31.

⁷² Neil Malcolm, 1994(i), op. cit., p. 174.

young people, especially in large cities, who have found work (normally involving trading, sometimes services, legal or illegal) which is well remunerated. The author's experience suggests that few of these people vote. However, if the possibility to trade freely or choose one's place of work became restricted, they would have the example of August 1991 to follow, and force the authorities through mass protests to again abandon attempts to turn back the clock. The effect of this precedent is rarely emphasized, yet its importance is enormous. It has largely contributed to a reversal in the mentality of young people from thinking that the authorities could never lose power, to the present position where most young people in populated centres do not think the prevailing authorities can regain control to the same extent as previously. More importantly, there is a widespread belief that they have a right to the relative freedom enjoyed at the moment. The freedom of choice of commodities, the lack of queues, the predictability of supply, the growing respect for consumers, the aesthetically pleasing goods and retail outlets — all these would suddenly stop being taken for granted.

This time, however, such protestors would not only be armed with bits of wood and metal. The employers of the young people described above comprise a slightly different class. Commonly also young, many of these 'New Russians' started trading early, often finding ways to export raw materials as well. Others merely exploited the real entrepreneurs through protection rackets. The majority of new bars and cafés, shops and restaurants, even small investment companies, are run by this type of 'biznessmen'. Many of these *nouveaux riches* have developed very close relations, at a price, with whichever politicians or bureaucrats whose approval they need for doing business, and whichever government those *chinovniki* work under, their help can be counted upon.⁷³ The world they deal in is ruthless, and the norm is for every such entrepreneur to be

⁷³ The author has, for example, seen well-placed politicians in the Urals being heartily supported by New Russian entrepreneurs. The politicians later lobby for them, and even supply Regional Budget funding for their businesses.

protected by many heavily armed guards. On a national scale, this represents a whole army which would be ready to defend their right to make money.

Yet another powerful group which would on the whole not want to risk losing their present economic freedom is that of the large enterprise directors. Contrarily to most of the people described above, these men tend to be middle-aged, were already successful under the Soviet system, and are also very well connected. Although most of these were CPSU members in the past, in order to climb to such senior positions, they would now be loathe to give up the financial rewards, and the opportunity to use these rewards freely, which they have gained in the last decade. Even if a Communist leadership were to come to power, this group would largely push for free trade with the Western world to continue, and the lobbying power of the large industrial directors is difficult to overestimate.

For all of these reasons, the author believes that the entire debate for or against closer relations with the EU in particular, and the West in general, has moved closer to the Westernizers' side. The context is not as it ever was before. Near total isolation from Western culture, commodities, technology, business practice and market opportunities, which existed before, is now truly improbable — even if a new Russian leadership pushes the present 'Slavophile' wave still further.

1.4 Moscow's Perspective on West European Integration

This section looks specifically at Soviet and Russian responses to integration in the Western part of the European continent, and in particular to the process of extending and deepening the integration of the European Community. The unofficial and almost entirely antagonistic relationship between the USSR and the EC before 1985 makes the high degree of interaction and moves towards closer political and economic relations in the early 1990s all the more remarkable.

Although it was only with Gorbachev that a truly positive relationship with the EC could be established, the previous degrees of harshness of Soviet criticism of the Community, and the reasons for it, have varied. There is a clear, though inconsistent, degree of correlation between the cycles of pro- and anti-Western feeling described in the first part of this chapter, and the variations in the Kremlin's open-mindedness regarding the Community.

In the decade that followed the signing of the first Community treaties in 1951 (the establishment of the European Coal and Steel Community with the Treaty of Paris), Moscow's reaction echoed Lenin's response to the proposition of a United States of Europe in 1917, which he described as 'either impossible or reactionary', and certain to collapse. The run-up to the signing of the Rome Treaty showed that Khrushchev's particular emphasis on Peaceful Coexistence with the West did not imply a great increase in tolerance towards occidental institution-building. When concrete plans for the EEC and Euratom were published in 1956, there followed a strong attack by the Kremlin, which instead advocated an atomic energy organization controlled by the United Nation's Economic Commission for Europe (UN ECE).⁷⁴ Just before the Rome meeting in 1957, the Six received notes from the Soviets warning against signing the Treaty, stating that it would be a threat to world peace and stability, and proposing instead an all-European economic cooperation organization under the auspices of the UN ECE. Moscow warned of both American imperialist monopolies and German revanchist forces. The fact that all EEC members were also part of NATO, thus making it in Soviet eyes an aggressive anti-Communist sub-group which complicated future European security, was pointed out by USSR spokesmen.⁷⁵ Moscow's onslaught on the EC continued after the signing of the Treaty of Rome with IMEMO's seventeen theses 'On the "Common Market" and Euratom'. These theses most notably described the EEC as a redivision of the

⁷⁴ Christopher A. P. Binns, 'The Development of the Soviet Policy Response to the EEC', *Co-existence*, vol. 14, no. 2, 1977, p. 244, from 'Zaiavlenie sovetskogo pravitel'stva ob obshcheevropeiskom sotrudnichestve v oblasti mirnogo ispol'zovaniia atomnoi energii', *Pravda*, 14 July 1956, p. 3.

⁷⁵ Peter van Ham, 1993, op. cit., p. 59.

world in the joint struggle amongst state-monopolies for new markets, as well as representing a concerted effort to reduce socialist influence, which was trying to compensate for the 'deteriorating' conditions of imperialism; the Community was seen as a tool of neo-colonialism.⁷⁶ Furthermore, the EEC was seen as an American-sponsored project designed to weaken the position of socialism on the continent, with the EC as an extension of NATO, and as a vehicle to allow German rearmament. The facts that Euratom was to be financed mostly by the USA, and that the enriched uranium necessary for nuclear generators would also be provided by Washington, fuelled Moscow's fear that the EC would simply be an American tool.⁷⁷

The serious proposals for a European Defence Community (EDC) in the early 1950s had not been forgotten by Moscow. Strongly supported by the Americans (especially because of the Korean War, starting in 1950, which seemed to confirm the inherent expansionism of Communism), and including the re-establishment of German armed forces, these plans were to haunt Soviet politicians and specialists long after the project was dropped in 1954. Although many Western writers dismissed this as paranoia, the fact remained that proposals for the resuscitation of an EDC continued to be heard, especially in West Germany, which wanted an EDC linked with NATO. As unlikely as it may now seem, even the British government was pushing for agreements on military integration of the EEC in the early 1970s.⁷⁸ Thus it is not unreasonable to suggest that Khrushchev may truly have seen the establishment of the EEC as a threat to security and stability in Europe.

Nevertheless, there seemed to be a lull in Soviet aggressiveness towards the Community in 1958 and up to early 1959, as the American recession and

⁷⁶ Christopher A. P. Binns, 'From U.S.E. to E.E.C.: the Soviet Analysis of European Integration under Capitalism', *Soviet Studies*, vol. 30, no. 2, 1978, pp. 245-47.

⁷⁷ Peter van Ham, 1993, op. cit., p. 59.

⁷⁸ Christopher A. P. Binns, 1977, op. cit., p. 257; taken from V. Levin, *Kommunist vooruzhonnykh sil*, 5 March 1973, pp. 81-85, and G. Kolosov and S. Madzoevsky, 'The Plans for Military Integration of Western Europe: the British Variant', *International Affairs*, Moscow, September 1973, pp. 52-58.

British antagonism to the EEC contrasted with Soviet sputniks successfully orbiting, and with Soviet growth rates also rocketing. There was a confident feeling that Moscow could simply wait for the Community to collapse. At a 1959 IMEMO Conference on the Common Market, not only were the main points of the Seventeen Theses repeated, but it was also stated that the EEC was not a reality in the historic sense, and that it should not to be taken seriously.⁷⁹

This confidence in the swift demise of the EEC was to be short-lived; from 1960, the Community appeared to be going from strength to strength, a trend which Moscow sought to challenge. There were many applications for EEC membership, including that of Great Britain, which further increased the likelihood that the EEC-EFTA rift could be bridged. The earliest phase of EEC integration had been fulfilled one year ahead of schedule (1 January 1962).⁸⁰ This period also saw dissent amongst West European Communists, as the Italian Communist Party began to admit that the EEC had played a vital role in Italy's 'economic miracle'. Adding insult to injury, the Italian CGIL delegation opposed the USSR's stance at the World Federation of Trade Unions' executive meeting in Budapest in May 1962, disagreeing that the EEC should be attacked, or that it could not benefit workers' living standards.⁸¹ The Italian trade unionists' reaction was symptomatic of the feeling in the whole of Western Europe. In the words of David Forte: 'it is difficult to describe the wave of confidence felt in most Western capitals about the progress of integration during the latter half of 1962. The Russians were also aware of it and the full significance of the trend it forbode.'⁸² These factors were most likely responsible for the propaganda offensive against the EEC which occurred around this time. The Soviets encouraged the World Federation of Trade Unions to promote labour unrest in Western Europe, although to little avail.

⁷⁹ David F. P. Forte, 'The Response of Soviet Foreign Policy to the Common Market, 1957-63', *Soviet Studies*, vol. 19, no. 3, 1968, p. 375.

⁸⁰ Peter van Ham, 1993, op. cit., p. 63.

⁸¹ Christopher A. P. Binns, 1977, op. cit., p. 246-48.

⁸² David F. P. Forte, op. cit., p. 379.

Moscow nonetheless continued to resist West European integration any way it could. At the International Conference on Contemporary Capitalism in August 1962, the USSR Academy of Sciences presented a new set of thirty-two theses on imperialist integration, arguing that the original Soviet analysis of the EEC's weakness and inevitable demise still applied. The thirty-two theses received two full pages of publicity in *Pravda*, far more than the 1957 theses, and this was only one of many articles published at this time on the subject.⁸³ Paradoxically, Western optimism about the EEC provoked a positive response as well as all the dogmatic criticisms; most interestingly, one relatively accommodating article towards the EEC was signed by Khrushchev. This piece spoke out against the inevitable collapse of the EEC due to imperialist contradiction, yet accepted that great benefits were being derived from the Community by its members; it acknowledged the 'objective tendency' towards the internationalization of production in the capitalist world, and accordingly perceived a need for greater socialist integration. Khrushchev apparently saw the desirability of cooperation not only amongst socialist nations, but also the possibility of closer economic cooperation both between individual states of different social systems, and between their economic unions. In a speech to the Central Committee in November, he argued that central planning in the CMEA should be able to outdo what the market was achieving in the EEC.⁸⁴

Thus already another cycle began to emerge which also influenced the Kremlin's attitude towards the Community. Not only were the overall cycles of Westernizer/Slavophile tendency pertinent, for example Khrushchev's generally more conciliatory stance towards Europe both East and West, allowing East European countries to conclude long-term trade agreements with the EEC;⁸⁵ there were also the ups and downs of Brussels' influence which often corresponded to changes in the tone of official Soviet statements on the Community. Major

⁸³ Christopher A. P. Binns, 1977, op. cit., pp. 248-49.

⁸⁴ Ibid., p. 250, and David F. P. Forte, op. cit., pp. 381-382; both referring to N. S. Khrushchev's article in *Kommunist*, no. 12, 1962.

⁸⁵ Peter van Ham, 1993, op. cit., p. 61.

increases in the perceived power of the EEC could be met by either particularly harsh attacks (for example, just before the Rome Treaty), or by extraordinarily benevolent statements (after the inclusion of Britain and Denmark, and during the preparations for the CSCE), or sometimes both, as in 1962. What is common is the noteworthiness of the response, always denoting an increase in the intensity of the discourse on the Common Market, and often a change in direction. Conversely, when Brussels' influence as seen from Moscow declines, so does the emphasis of government commentary, and there can even be a return to the previous stance. A case in point is that six months after Khrushchev's article in *Kommunist*, as the process of integration in the West had again faltered, there was a clear return to anti-European dogma, and new life given to the infallibility of imperialist contradiction.⁸⁶ We shall see that this tendency to react to shifts in EEC clout, though by no means absolute, continues to play a part to the present day.

In the first decade after Khrushchev was overthrown, despite lesser emphasis on the doctrine of Peaceful Coexistence, there were many occasions when relations between Moscow and Brussels seemed to be improving. There was a further blow to the conspiracy theory that the Community was merely a tool to attack the socialist world⁸⁷ when specialists from IMEMO stated in 1965 that

the process of 'integration' (in Western Europe) [...] is an attempt by the financial oligarchy to find a 'constructive answer' to the objective needs of contemporary productive forces, which have long ago grown beyond the possibilities of private property satisfying the needs of production, and call out for the essential shift to a higher system — socialism.⁸⁸

⁸⁶ David F. P. Forte, op. cit., p. 383.

⁸⁷ Vladimir Baranovskii, 'The EC Seen from Moscow' in *Russia and Europe — an End to Confrontation?*, ed. Neil Malcolm, London, 1994, p. 62.

⁸⁸ 'Mezhdunarodnye otnosheniia posle vtoroi mirovoi voiny', IMEMO, Moscow, vol. 3, 1965, p. 27.

Although this article still alludes to the constant and conscious attacks on socialism by Western Europe, it nonetheless portrays the Community as a higher level of social and economic development.

The late 1960s and early 1970s again saw a strengthening of the Community's international role, and again provoked a reaction from the Soviet leadership. Many favourable statements emerged about the EC's role as an instrument to defend West European interests against the USA; Moscow became more optimistic about the future of the EC in world politics. In particular, the European Political Cooperation (EPC) procedure, set up at President Pompidou's suggestion at The Hague summit in 1969, was seen by many in Moscow as a positive sign that the EC was acquiring more independence from the USA,⁸⁹ contrarily to the early 1960s when any political integration was predominantly perceived as being inherently anti-Soviet, and limiting Moscow's ability to play off West European states against each other.⁹⁰ It was on this wave of relative optimism that Brezhnev (in 1972) talked of the desirability of building 'business-like relations' between the CMEA and the EC.⁹¹ Official relations between the CMEA and the EC experienced a thaw at this time; after having ignored the Commission and instead addressed the Presidency of the EC Council for a long time, in September 1974 the CMEA Secretary Fadeev accepted the EC's offer to negotiate by inviting the Commission's President François Xavier Ortoli to Moscow. Brussels wanted instead to start negotiations at a lower level (not being eager to encourage a consolidation of Comecon). Thus in early 1975 Directors of the Departments of External Relations of both the Commission and the CMEA Secretariat met; in this event, however, the high level of the EC delegates was not matched by the standing of the CMEA representatives. Despite the lack of success at the first meeting, the EC invited a CMEA delegation to Brussels to try again, especially keen to achieve agreements on transport, statistics, economic

⁸⁹ Hannes Adomeit, 'Soviet Policy Perspectives of Western European Integration: Ideological Distortion or Realistic Assessment?', *Millennium*, vol. 8, no. 1, 1979, pp. 10-13.

⁹⁰ View expressed by Vladimir Baranovskii, at a study group at the RIIA, London, June 1991.

⁹¹ Vladimir Baranovskii, 1994, op. cit., p. 63.

forecasting, technical standards and environment — but the CMEA failed to respond to this invitation.⁹² The ease with which these negotiations collapsed reflected the return of aggressive superpower politics in the mid-1970s.

Even before the onset of Cold War II, a main bone of contention had limited the impact of more pro-European tendencies — the possibility of Britain joining the Community. This was partly because such a move would really transform the EEC into a force to be contended with, as it was widely expected that the other Eftans would soon follow suit, thus no longer leaving Western Europe almost equally divided into two. At least as important was the fear that Washington would start having more influence on the EEC through London.⁹³ Moscow's vigorous campaign to persuade the Community not to admit Britain was to be in vain, but with typical pragmatism, and aided by what still remained of détente, the inevitable was accepted without preventing the above-mentioned attempts at a CMEA-EEC agreement.

With the re-freezing of East-West relations, however, the Community tended to be either ignored or insulted. The sharp deterioration in the EC's economic situation, especially the OPEC crisis and recession, were used by Moscow as proof of the Community's failure. Later on, in the early 1980s, the Kremlin was worried by what it saw as the American counter-offensive to reassert its dominance in Western Europe.⁹⁴

Yet it was also during the early 1980s that the economic arguments for integration started to become particularly powerful. Regional economic integration, such as that of the EC, came to be seen as an intermediate phase on the way to further internationalization, the next step perhaps being on an Atlantic scale. It was generally regarded as positive, except by a minority of scholars including Anatolii Shapiro⁹⁵ and G. Sorokin,⁹⁶ who argued that the capitalist and

⁹² Peter van Ham, 1993, op. cit., p. 129.

⁹³ Ibid., pp. 68-69.

⁹⁴ Hannes Adomeit, 1979, op. cit., p. 21.

⁹⁵ Anatolii Shapiro, 'Eshche raz k voprosu o teorii vseirnogo khoziaistva', *MEMO*, no. 3, 1985, pp. 91-102.

socialist world-systems were still economically 'incompatible and antagonistic', and that it was therefore desirable to be as independent from capitalist economies as possible. Other economists, such as Iu. Shishkov⁹⁷ and E. Pletnev,⁹⁸ took the middle ground, writing for example that, although there was increasing interdependence between the economies of the two systems, they were clearly distinct, and that the all-world economy 'is not a real organic economy but a sterilized theoretical abstract', with objective limits to interdependence which are dangerous to cross (perhaps meaning Polish debt).⁹⁹ Yet a growing body of specialists, many also from IMEMO, saw the world economy as an integral unit. The philosopher Fedor Burlatskii was one of the earlier proponents of this view, writing in 1982 (in an article purportedly on China) that any contemporary economy cannot develop adequately without close economic ties with other countries, and participation in the international economic division of labour; he also suggested that the economy should be set up in such a way as to be corrected by economic, and not administrative measures.¹⁰⁰ This helped clear the way for economists such as M. Bunkina and N. Petrov, who later criticized the concept of two distinct socialist and capitalist economies, as taught to foreign policy and foreign trade officials. They argued that the stage for the class struggle was now the global economy; adding that the only way to achieve global peaceful coexistence was to have international economic cooperation.¹⁰¹ Such specialists therefore joined the Europeanist ranks in warning against isolation from the thriving West European market.

⁹⁶ G. Sorokin, 'Problemy teorii vseirnogo khoziaistva', *Voprosy ekonomiki*, no. 5, 1983, pp. 127-37.

⁹⁷ Iu. Shishkov, 'K voprosu o edinstve sovremennogo vseirnogo khoziaistva', *MEMO*, no. 8, 1984, pp. 72-83.

⁹⁸ E. Pletnev, 'Za politiko-ekonomicheskii podkhod k kategorii vseirnogo khoziaistva', *MEMO*, no. 7, 1985, pp. 106-13.

⁹⁹ Stephen Shenfield, *op. cit.*, p. 66.

¹⁰⁰ Fedor Burlatskii, 'Mezhdutsarstvie, ili khronika vremen Den Syaopina', *Novyi Mir*, no. 4, 1982, p. 224.

¹⁰¹ M. Bunkina and N. Petrov, 'Vseirnoe khoziaistvo — ekonomicheskii fundament mirnogo sosushchestvovaniia', *MEMO*, no. 9, 1986, pp. 56-57.

Gorbachev truly revolutionized the Soviet approach to the EC. Although the Community had been acknowledged *de facto* by the Soviet government in 1962 through Khrushchev's article, and then in the 1970s when there were negotiations on trade agreements, it had never been treated as a potential ally. The overwhelming Westernist current of the late 1980s, however, allowed the above pro-integration economic theories to influence foreign policy, and Gorbachev soon went far beyond treating Europe as a simple American 'marionette'. In other words, Moscow's reaction to this particular period of strengthening of intergration in the EC was very positive and cooperative; it was at least as remarkable and progressive as the signing of the 'Single European Act' (1985).

In the same year Gorbachev went to the Council of Europe with his visionary 'Common European Home'. With the strong emergence of New Political Thinking, academics made much use of their new-found freedom, usually in support of pro-European policies. The interest was all the greater as the prospect of a truly single market (in 1992) neared. Yurii Borko described West European integration as a mass phenomenon, supported not only by bourgeois circles, but also by working class organizations and by the 'democratic' intelligentsia.¹⁰² In a new set of theses on the European Community in 1988, IMEMO described West European integration as a progressive tendency towards the strengthening of communications between states, and stressed its capacity to exert a positive influence on relations between all the states of Europe, reducing military tension and paving the way for mutually beneficial cooperation agreements.¹⁰³ The following year another important publication by Vladimir Baranovskii's West European Department of IMEMO also put forward a very positive view of the EC integration process, suggesting that it would allow Europe to compete on better terms with the USA and Japan, permitting the Community to achieve an increase of between 4.5-7.0% of its GDP by abolishing internal trade

¹⁰² Iurii Borko, 'O nekotorykh aspektakh izucheniia protsessov zapadnoevropeiskoi integratsii', *MEMO*, no. 2, 1988, p. 37.

¹⁰³ IMEMO, 'Evropeiskoe soobshchestvo segodnia', *MEMO*, no. 12, 1988, pp. 5-18.

tariffs and rationalizing the division of labour, a reduction in inflation by 4.5-6.0%, and an increase in the number of jobs by 1.5-5.0 million as a result of the single market. These 'Three Theses' also acknowledged some of the negative sides of West European integration. These paled, however, in comparison with the expected advantages of the Single Market. Despite the lesser flexibility if ever funding for the USSR could not be obtained through the individual EC countries, there was still likely to be more credit available once it was centralized, as the EC economy would in any case be stronger, and not least because the Community's increasingly common foreign policy, with its emphasis on pan-European issues, would look more kindly upon Soviet requests. Although exporters of manufactured goods would find it more difficult, exporters of raw materials would see an increase in demand, due to the increased rate of economic growth in the West. The USSR had acquired a strong new partner in foreign affairs, according to IMEMO. Not only that, but the integrated Western Europe could be seen as all the more ready to then be joined to the Eastern part of the Common European Home.¹⁰⁴

By the end of the 1980s the CMEA was crumbling, and the European Community was important both as cause and effect. For as long as the Community has existed, it has had an effect on Comecon. We have already noted that Khrushchev called for greater integration of the Eastern Bloc to compete with Western Europe. As the number of trade agreements between East European countries and the EC multiplied in the 1960s, there was a strong incentive for Moscow to keep a tighter hold of the CMEA states' foreign economic ties. It has been argued that the main reason for both the revival of the CMEA in the mid-1950s, and its further integration at the end of the 1960s, was not a desperate need to compete with the EEC, but rather a reaction to insubordination by Moscow's East European partners.¹⁰⁵ This was definitely a major factor, but it must be recognized that this East European tendency to seek agreements with

¹⁰⁴ IMEMO (West European Department), 'Posledstviia formirovaniia edinogo rynka Evropeiskogo Soobshchestva', *MEMO*, no. 4, 1989, pp. 38-44.

¹⁰⁵ Christopher A. P. Binns, 1977, *op. cit.*, pp. 240-60.

Brussels was a result of the Community's success and economic strength; in other words, Moscow's concerns about the Community's economic and political successes, and the worries about disobedience by its allies, were to a large degree two sides of the same coin. All the same issues re-emerged in the mid- to late 1980s. There was another attempt to breathe new life into Comecon, partly to keep up with the prestige and power of the Community, and partly to prevent members from abandoning this alliance. A rejuvenated CMEA was often seen as the foundations for the Eastern section of the new European structure. As late as December 1989, Gorbachev suggested that the first step towards a European economic area should be a mechanism of consultation between the EC, the EFTA and the CMEA.¹⁰⁶

By this time, however, counting on a strong Comecon was clearly against all odds. Although the EC went from strength to strength whilst the Eastern Bloc collapsed, it is remarkable that Soviet policy did not become defensive and antagonistic overall; this time the result of greater EC integration, in terms of Eastern Bloc cohesiveness, was to be the opposite of that in the 1950s and 1960s. By the summer of 1988 the CMEA had signed a Joint Declaration with the EC, and the USSR was soon to follow with a Trade and Cooperation Agreement in December 1989 (see Chapter Two). Despite the incalculable loss of the East European buffer zone, New Political Thinking still prevailed.

There was, of course, an increase in conservative opposition to the passivity of Soviet policy towards Eastern Europe, as there was towards the acceptance of the establishment of the Single Market. Nonetheless, Gorbachev's government seemed to have come to the conclusion that trying to create a fuss over the Single Market would destroy much that had been achieved in improving the Soviet Union's image in Europe, and would have been unlikely to have achieved much in any case. The chances of rapid positive results of the Kremlin's European policy had to be over-emphasized and the risks played down in order to keep domestic criticism to a minimum, and to show enthusiasm to the

¹⁰⁶ Gerhard Wettig, 1991, *op. cit.*, p. 96.

West. In 1990, the head of IMEMO's West European Department pointed out that the imminent Single Market, the EC's increasing involvement in foreign policy and the relative decline of the international importance of NATO all made closer relations with the Community extremely desirable. Baranovskii added that 'there is more than enough basis to assume that the EC will increasingly become the heart, the nucleus of the regional (all-European) international system'.¹⁰⁷ This optimism about Europe was still reflected in government policy also, as shown by the Delors-Gorbachev meeting in the summer of 1991, and the negotiations for a more binding agreement between the EC and Russia.

The *status quo* was changed unrecognizably by the collapse of the USSR and the emergence of the new Russian government as its successor; but despite the growing tendency for New Realism in foreign policy, the approach to the Community was left much the same. This is one of many indications that the 'New Realism' of this period was centrist in many aspects, and not as anti-Western as foreign policy was to become in 1994, nor as defensive and/or distrustful as hard-line Realism as generally understood in Western international relations theory. During his visit to the European Parliament in April 1991, El'tsin had declared his intention to 'repair a historical injustice' and to 'return to the European Home'. Although the intensity with which El'tsin has pursued the European goal has varied, the basic direction has not.

Attitudes remained positive about the Community even as it was about to become still more integrated through the fulfillment of the Maastricht Treaty. An article in *International Affairs* of March 1993 gave a very flattering perspective of the evolution of the EC up to Maastricht, and was positive about the changes expected once that Treaty was enacted, stating that the increased powers of the Parliament and greater number of issues decided through qualified majority voting represented 'a shift towards intensifying the supranational character of the European Communities'.¹⁰⁸ Although noting the risk of greater isolation of

¹⁰⁷ Vladimir Georgievich Baranovskii, 1990, op. cit., p. 13.

¹⁰⁸ Valerii Gorskii and Elena Chebotareva, 'Maastricht and Russia', *International Affairs*, Moscow, March 1993, pp. 46-51.

Russia, they emphasize the stabilizing effect of the Union not only on West European economies, but consequently on intra-regional trade, as well as the likely increase in major pan-European projects in the field of energy, transport, communications and human resources development, 'which are of great interest to Russia'.¹⁰⁹ The established Westernizer Andrei Zagorskii continued supporting greater efforts to establish closer economic and political ties with the Community, pointing out in the summer of 1993 that the EC is not only an economic alliance, but the beginning of a West European political union, which will soon include more neutral countries as well, adding that 'the degree of Russia's future involvement in European affairs will greatly depend on how relations between her and the EC will develop'.¹¹⁰ This kind of pro-European feeling was still expressed by the Foreign Minister as late as October 1993, when he stated that 'Russia's choice is an all-European choice in favour of freedom, private ownership and the rule of law'.¹¹¹ It should be pointed out that despite being much less unambiguously pro-integration with the EC than 'New Thinkers', Russian New Realists have tended to recognize that EC integration is inevitable, and that there is still much benefit to Russia to be gained from closer political and economic relations with the Twelve (in this, New Realism differed from hardline Realism as commonly perceived in the West, which would minimize dependence on multinational organizations such as the EC). What had changed, as shall be examined further on, was the level of hope and trust in Western Europe's capacity, and even willingness, to help.

Throughout the post-Soviet period, domestic criticisms of Moscow's pro-Western policies were greater than ever, following the shift to Eurasianism and even nationalist-populism. The general shift away from the Russia-Western world honeymoon was reflected also in attitudes towards the EC. Amongst an increasing number of public figures, there has been ever-louder evidence of what Baranovskii has called 'residual superpower complex'; they could not resign

¹⁰⁹ Ibid.

¹¹⁰ *Moskovskie novosti*, no. 24, 13 June 1993.

¹¹¹ Andrei Kozyrev's speech at the RIIA, October 1993.

themselves to Russia having to accept the role of mere regional power, on a par with that of the EC, nor to attempts to limit its geostrategic power in order to appease Western fears. The complaints examined above concerning the betrayal of Russia's security interests, cheaply selling off Russia's natural wealth, and granting the West control over Russia's affairs, have all been directed against Europe. It is noticeable, however, that these attacks are almost invariably either based on petty issues (such as the complaints about selling black earth, mentioned earlier), or are very general and superficial. The attacks on the Community, and Russia's attempts to form a closer relationship with it, have normally been delivered by people with no real knowledge of Western Europe. There are two main areas of serious complaint which are exceptions — the dangers of Russian isolation, and the prolongation of EC trade restrictions on Russian exports; both are detailed below.

The modern-day Slavophiles naturally abhor the idea of designing any aspect of the new Russia according to EC blueprints; Russia should count on its strong moral character and rich history, rather than follow plans which would make of her a second-class nation and a colonial supplier of raw materials.¹¹² Yet it is not only the anti-Western camp which has warned against reliance upon the Community's example as the best road to growth. One commentator, having analysed the problems of Maastricht and found them minimal, nonetheless discarded the idea of closely comparing the CIS to the EC, as the levels of economic development are so different; 'here there is no market, the level of technology is low and political culture is lacking'.¹¹³

On the whole, however, there has been much positive analysis of the Community as a framework which could be useful to Russia. Valerii Gorskii and Elena Chebotareva, for example, wrote that although the EC is obviously very different from the CIS, the positive as well as the negative experiences of the EC should be borrowed by Russia and her partners, not only for their own use, but

¹¹² As an example, see Mikhail Lemeshev, *op. cit.*, pp. 119-20.

¹¹³ Dmitrii Pogorzelskii, *New Times*, no. 52, 1991, p. 30.

also to assist relations with the Community.¹¹⁴ Elena Volkova wrote that Russia's European policy is also of importance in resolving domestic problems, as an analysis of the situation in Europe could help clarify and correct some of the Russian Federation's contemporary problems, or at least provide suggestions as to how to solve them. She refers in particular to the question of sovereignty, not only that of Russia over the other republics, but within Russia itself.¹¹⁵ Baranovskii confirms that in the first two months after the 1991 *coup* there was much debate about the nature of the political union which should succeed the USSR, and that the EC was a major influence in this debate — 'the EC model now represented a kind of maximalist strategy for preserving the union'. In particular, the concept of 'variable geometry' was interesting in the post-*coup* period. Baranovskii added that the EC structure should be copied on a pan-European scale in many spheres, to reduce the threat of violence in the same way as it had been reduced in Western Europe.¹¹⁶ This idea of spreading the formula of the Community, whilst implying that the EC itself need not expand, is shared by Karaganov¹¹⁷ and other top-level specialists. These calls to use EC experience as a way out of domestic political problems in Russia remained academic, however, and were not explicitly used by the Russian government.

For all the positive comments about West European integration, calls to quickly become sufficiently compatible with the EC and to aspire to full membership have been very rare. It has been suggested that Russia bring its export standards up to those of the EC,¹¹⁸ or even that the new legal system should be comparable with those of the Community,¹¹⁹ but only in the interest of

¹¹⁴ Valerii Gorskii and Elena Chebotareva, *op. cit.*, p. 52.

¹¹⁵ Elena Volkova, 'Vneshnaia politika Rossii: evropeiskii kontekst', *MEMO*, no. 9, 1992(ii), p. 20.

¹¹⁶ Vladimir Baranovskii, 1994, *op. cit.*, p. 75.

¹¹⁷ Sergei A. Karaganov, 'Towards a New Security System in Europe' in *Gorbachev and Europe*, eds V. Harle and J. Iivonen, London, 1990, p. 44.

¹¹⁸ *IMEMO*, 1989, *op. cit.*, p. 42 — one of very many examples.

¹¹⁹ An overall theme at the 'Europe-USSR: Law and Cooperation' International Forum, 21-24 October 1991; but see for example A. I. Dolgova's paper 'Market Relations and Criminality: Criminological Problems, Problems of the Transition Period'.

greater and closer cooperation, not the actual merging of Russia and the Community. It was clearer than ever, under El'tsin, that the *rapprochement* with the Community could only go so far. Russia's Ambassador to the EC, Ivan Silaev, admitted in August 1992 that Russia was not aiming at full membership of the EC, saying that 'our economy is completely incompatible with what you have in the European Community'.¹²⁰

Accepting the inevitability of remaining outside the Community did not mean that Moscow was not going to push for close cooperation, however. From the beginning of the negotiations on the new 'Partnership' agreement, which was to replace the Cooperation and Trade Agreement with the USSR, it was clear that Russia was aiming at a much more far-reaching agreement than the Commission was at first able to grant. As the EC has tended to be in the driving seat during these negotiations, most of the details are dealt with in the next chapter. It is worth emphasizing at this stage, though, that Russia was particularly looking for a guarantee of the 'four freedoms' of goods, services, capital and persons.¹²¹ Some of the more pressing problems caused by this were in the services industry, especially over transportation and commercial satellite launches.¹²² On specific restrictions, the Russian Deputy Prime Minister Aleksandr Shokhin listed several goods on which agreement had still evaded the negotiators in the fourth round of negotiations (in May 1993): steel, aluminium, coal, uranium, textiles and space technology.¹²³ Russia was requesting tariff concessions on all of these exports.¹²⁴ Shokhin also expressed dissatisfaction at the proposed treatment of Russian companies in the EC, although it was unclear why the Russian delegation was unhappy with the official position of the EC, which called for EC companies operating in Russia to have the choice between MFN treatment or that of national

¹²⁰ *The Guardian*, 19 August 1992.

¹²¹ *Europe*, 4 June 1993.

¹²² *Kommersant*''', 1 June 1993.

¹²³ *Kommersant*''', 29 May 1993.

¹²⁴ *Europe*, 4 June 1993.

companies, and Russian companies in the EC to benefit from national treatment in the country of establishment.¹²⁵

The significance of this Russian drive to be accepted as a partner of the EC is critical. There are few clearer indicators of the degree of pro-integrationism within the Kremlin at the beginning of the 1990s than the requests, at the risk of embarrassing refusals, to allow Russia free movement of people, money and commodities within the EC. This clearly shows Russia's desire to be seen as a fully-fledged member of the European continent. Although the drive for this acceptance was to be weakened, and official statements to become much more independent and defensive, the basic desire to become as compatible as possible with Western Europe is still clearly present in early 1996.

Back in 1993, however, the frustration of fruitless negotiations, helped no doubt by the general pressure to seem less dependent on Western Europe, resulted in very angry comments by the Russian authorities. The Minister of Foreign Economic Ties, Sergei Glazev, stated that the EC's discriminatory measures against Russian trade should be seen as a trade war unless they were soon rectified. Glazev tried to argue that in foreign trade, disappointingly, Russia was now more free-market than EC countries, as there were no longer any export subsidies, and import tariffs were very low, as were the numbers of quotas. Russia was nonetheless to take a further measure to avoid this trade war — a declaration was soon to be delivered by El'tsin on Russia's desire to become a full member of GATT.¹²⁶ As examined in Chapter Two, this would be a tremendous boost to the chances of achieving a free trade agreement between Russia and the European Union.

It is noteworthy that even on this most contentious issue of trade restrictions, the more pro-reform organs were willing to see Brussels' point of view. In a very conciliatory article, *Kommersant*¹²⁷ tried to explain the EC's reluctance to open up its markets to Russia using a table exposing the following

¹²⁵ *Europe*, 1 April 1993.

¹²⁶ *Kommersant*¹²⁷, 27 and 29 May 1993.

points: the EC's 1992 trade deficit of \$90bn¹²⁷ with the rest of the world; France's expected zero growth and Germany's slight decline, whilst the USA expected to see a rise of 3.3% and Japan of 0.8%, and so on.¹²⁸ Another commentator lamented the obstinacy with which Russia was refusing to reach agreement without achieving all its economic aims, thus risking the loss of very important advances in political relations with Europe — 'Is it then worth delaying the establishment of the basis for political interaction because of the unsettled trade relations? Clearly, no'.¹²⁹

The economic aspect of the negotiations was particularly difficult to separate from the political ones, because what was in effect being called for by the Russian government was the establishment of a new European Economic Area, which would extend to the Pacific. This was not an old-fashioned attempt to create a new system in order to weaken or even replace the Community; the fact that Moscow needed Brussels to agree to the plan meant that the European Union would remain the core of the new European economic arrangement. The call for a pan-European free-trade area to start being established before the end of the century was the most important part of the new agreement being negotiated; it was the solution to Moscow's greatest worry about the new Europe — that it not be isolated from it.

Ever since there was a likelihood of Moscow losing its East European allies, the threat of standing alone against the rest of Europe has loomed large in Soviet and Russian writing. Many writers believed that the strengthening of the EC would go against the unity (*tselostnost'*) of Europe.¹³⁰ The possibility of a Europe 'from Brest to Brest' was warned of by Borko and Orlov in 1990, and concern was expressed about the balance of power in Europe.¹³¹ This latter point had by then lost most of its validity, however, as the balance of power had

127 Throughout this thesis, a \$ sign refers to US dollars, unless otherwise indicated.

128 *Kommersant*''', 29 May 1993.

129 Andrei Zagorskii, *Moskovskie novosti*, no. 24, 13 June 1993.

130 Gerhard Wettig, 1991, op. cit., p. 95.

131 Iu. Borko and B. Orlov, op. cit., p. 54.

already been destroyed, and it is this dissolution of the previous balance of power which had permitted the restructuring of European institutions and alliances. In fearing isolation of the then Soviet Union, however, Borko and Orlov were in good company. Baranovskii noted the danger of a new 'fault line' of Europe appearing at the Western border of the USSR.¹³² Karaganov's wording of this concern was that

there is the most undesirable possibility that 1992 will cement the economic and even the spiritual base of the military divide in Europe. [...] this could happen by default if the process is not balanced by correctives, not only in military, political, cultural and humanitarian fields but also in the economic field.¹³³

Volkova also expressed concern at the new polarity of Europe, between a wealthy Western part and an Eastern 'grey zone',¹³⁴ whilst Gorskii and Chebotareva noted that with an ever increasing part of Europe submitting itself to EC rules and regulations, Russia may well lose much of its trade.¹³⁵

Contrarily to the many blatantly xenophobic attacks by extreme nationalists on the *rapprochement* between Eastern Europe and the EC, however, all the specialists quoted above have balanced the threat of isolation with the opportunity for unparalleled cooperation with Western Europe. Paradoxically, West European integration threatens to isolate Russia, but at the same time it provides new hope for Russian input and interaction in Europe which had hitherto been unthinkable. Still in 1993, many Europeanists saw deeper integration in the European Union as a step towards greater integration on the continent as a whole. The opinion that the consequent strengthening of the EU's economy may lead to more trans-European investment has already been noted. Often repeated is the positive effect of the stability of the Community on the rest of Europe (despite its failure to prevent the Yugoslav crisis), and this would only be enhanced by

¹³² Vladimir Baranovskii, 1990, op. cit., p. 10.

¹³³ Sergei Karaganov, op. cit., p. 46.

¹³⁴ Elena Volkova, 1992(ii), op. cit., p. 23.

¹³⁵ Valerii Gorskii and Elena Chebotareva, op. cit., p. 51.

further integration. Baranovskii strongly emphasizes the advantage of the EU becoming a strong power in every sense — ‘a more powerful EC could minimize uneasiness in respect of the size and potential capabilities of Russia and reduce the likelihood of it being excluded from European affairs’.¹³⁶ The need to make every effort to improve relations with Western Europe (and even trying to encourage a cooperative approach towards the EU with FSU states¹³⁷), and to implement EU standards which would facilitate freer trade, are all recommended by this group.

Although Russian politicians and diplomats have been on the whole much less enthusiastic than the above academics, especially from 1993 onwards, nevertheless the main direction of Russia-EC policy remained similar. It can be argued that there was little choice. It seems clear that the Maastricht Treaty will be, at least mostly, realized, and that the Visegrad Group will be able to join the Union. Russian complaints would not halt the process. In economic terms also, it would have been foolish for Russia to miss the opportunity for increased trade and investment that would follow a closer Partnership Agreement. Thus, despite the overall decrease in warmth of relations with the West, and strong pressure to once again look the part of a superpower, Russia remained on good working terms with Brussels, and might even enter a European Economic Area before the end of the century, should reformers win the day. Although Russia’s more irksome behaviour in the last few years, whether on the international stage or in the Caucasus, has shown a lesser degree of readiness to act exactly as the West would like, Moscow has nevertheless wanted to build on existing successes towards closer ties with Western Europe. At the CSCE Summit in 1994, El’tsin attacked those in the West who were giving up on the Russian democratic process, and were ready to exclude Russia altogether from European integration. In the spring of 1995, the suspension of the ratification of the Partnership Agreement, and of the approval procedure for Russia’s membership of the

¹³⁶ Vladimir Baranovskii, 1994, *op. cit.*, p. 76.

¹³⁷ Elena Volkova, 1992(ii), *op. cit.*, p. 23.

Council of Europe, caused very strong protest from the Russian government.¹³⁸ Moscow has by no means given up on the possibility of becoming a more integral part of Europe.

1.5 Germany's Special Position

Germany has played a particularly important role as an advocate of greater integration of Russia into Europe, and in turn Moscow has tried particularly hard to keep relations with Bonn as positive as possible. Germany's approach to the integration of Russia into European structures is explored in the next chapter, whilst this section concentrates on Moscow's reactions.

The first real positive change in the Kremlin's attitude to West Germany, and to the possibility of German reunification, came with Gorbachev's response to proposals by the German President, Richard von Weizsäcker, during his meeting with Gorbachev in July 1987. 'What happens in a hundred years' time', said Gorbachev, talking about the possibility of reunification, 'history will decide'. Almost imperceptibly, a massive shift had occurred. This was no longer the theory of the 'diverging paths' of the two German states; it opened up the possibility of preparing for eventual reunification.¹³⁹ The improvement in relations was confirmed by the Soviet-German Joint Declaration which was signed in July 1989, committing both parties to the 'precedence of international law in domestic and international politics'. This did not mean, however, that the idea of unification was not still met with hostility; in Paris in July 1989, Gorbachev repeated that such hopes were unrealistic, whilst in a speech to the Supreme Soviet in November Shevardnadze said that security and peace in Europe rested on the existence of two Germanys. Yet in both these speeches,

¹³⁸ Heinz Timmermann, 'Rußland und Deutschland: Ihre Beziehungen als integraler Bestandteil gesamteuropäischer Kooperation', *Berichte des Bundesinstituts für ostwissenschaftliche und internationale Studien*, no. 39, 1995, pp. 15 and 22.

¹³⁹ Fred Oldenburg, 'The Settlement with Germany' in *Russia and Europe — an End to Confrontation?*, ed. Neil Malcolm, London, 1994, pp. 102-03.

another way forward was suggested; Gorbachev stated that a solution to the German problem could be found in a new pan-European framework, whilst his Foreign Minister declared more specifically that Moscow could agree to changes in the historical *status quo* if they were reached in a CSCE framework.¹⁴⁰ Proposals not including a European structure, however, such as Chancellor Kohl's 'Ten Points' plan, put forward on 28 November 1989, met with a very negative response in Moscow.¹⁴¹ In other words, Moscow wanted not only general goodwill from the West in exchange for not forbidding German reunification, but also wanted, in particular, to obtain a key place in a new European structure. Avoiding isolation was the main priority.

When Shevardnadze conceded in May 1990 that intra-German and European integrations did not have to coincide, this was conditional upon dual membership, which was described as a neat way to begin cooperation, and eventually the merger, of both organizations; there was also an insistence upon the four powers maintaining their responsibilities in Germany until agreement could be reached upon a new security structure.¹⁴² It is important to note that the EC was not seen as an adequate security partner for the USSR because it did not cover the whole of Western Europe. What Moscow wanted was a structure which covered the whole continent, and wherein it would hold sway.

Such was the momentum towards reunification, however, that the Soviets feared being presented with a *fait accompli* which disregarded the agreements already reached at the Ottawa Two-plus-Four meeting in February 1990, especially as the West German constitution could be seen to sanction the assimilation of Eastern Germany. Moscow's criticism could only be constructive, in order to avoid the risk of being totally disregarded. In the end, Soviet officials cleverly made a virtue of necessity by starting to claim that a united Germany was a pre-condition for the establishment of a Common European Home. Shevardnadze said in June 1990 that the unification of Germany had formed 'a

¹⁴⁰ Gerhard Wettig, 1991, op. cit., pp. 154-56.

¹⁴¹ Ibid., p. 157.

¹⁴² Ibid., p. 163.

load-bearing structure of the Common European House', and Gorbachev stated in Bonn in November that 'Our concord and cooperation make up parts of the load-sharing structures of the "Common European House"'.¹⁴³ In the end, however, Moscow was not able to secure any commitment to the building of a strong pan-European structure around this pillar; isolation remained a danger. All Gorbachev managed to salvage from negotiations on reunification was a reduction of German troops by over 40%, an exclusion of nuclear weapons and foreign troops from the Eastern Länder, finality of German borders, and inaccessibility of nuclear warhead delivery systems to German troops.

For many of the more conservative elements, the loss of East Germany was the cracking point, whereafter they ceased to accept reforms. With the rise in Eurasianism that followed in the 1990s, distrust of Germany's future role spread to a wider base. Even the liberal Baranovskii asked whether the new disbalance in Europe, with Germany as a superpower, could not in itself be a source of threat to stability in Europe.¹⁴⁴ The one supranational European organization which was growing in strength, the EU, was also a disappointment to Russian hopes of German containment. Faina Novak wrote that Germany dominates the EC to such an extent that the 'destiny and pace of further integration largely depend on its positions'; she adds that Germany seems to be finding the structure of the Twelve increasingly confining, and is pushing for expansion eastwards.¹⁴⁵ The unspoken aversion to Germany regaining control over its former hinterland of Eastern Europe, through the EU, was shared by Aleksandr Bykov. He warned against granting too much influence to Germany, and said that Russia needs to establish links with all main powers, so as not to restrict its options and thus become vulnerable.¹⁴⁶

¹⁴³ S. Smol'nikov, 'Novaia logika evropeiskogo razvitiia', *MEMO*, no. 6, 1990, p. 28; and *Soviet News*, 4 July 1990 and 14 November 1990.

¹⁴⁴ Vladimir Georgievich Baranovskii, 'Neobkhodimost' novykh podkhodov' (a roundtable of specialists from IMEMO and IMEPI, on new security arrangements in Europe), *MEMO*, no. 8, 1992, pp. 97.

¹⁴⁵ Faina Novak, 'Russia and Germany', *International Affairs*, Moscow, no. 12, 1992, p. 112.

¹⁴⁶ Alexander Bykov, 'Russia and Germany', *International Affairs*, Moscow, no. 12, 1992, pp. 116-18.

At the same time, however, there were signs of a potential re-emergence of the close 'special relationship' between Russia and Germany. Not all commentators are negative about Germany's power; Andrei Zagorskii, for example, deplored the two simplistic notions of Europe now prevailing in Russian society, one of them being an exaggeration of the role of the new Germany.¹⁴⁷ Boris Shmelev stressed the potential for close cooperation between Russia and Germany, singling out the Kaliningrad region as ideal for the establishment of a joint Special Economic Zone.¹⁴⁸ In early 1993, it was reported that 'top foreign policy advisers' to El'tsin expressed anger at Russia being sidelined in international affairs, and stated that 'only Germany still has Russia's confidence' and could allow Russia to stand up to the USA.¹⁴⁹ In a June 1993 poll conducted by the All-Russian Centre for Public Opinion, only 4% of Russian policy-makers and experts named the USA as Russia's number one friend, whilst 22% chose Germany.¹⁵⁰

The overall trend amongst foreign policy decision-makers, however, has been to remain somewhat closer to Germany than to other Western powers, but in a multilateral framework. Statements suggesting an exclusive association with Germany should be seen in the light of Russia's frustration with the international community, and as an eventual hedge if Germany does break away from the EU, but not a serious intention in the short- or medium-term. As Shmelev pointed out, 'it is already clear, [...] in developing cooperation with Germany, that Russia must take into account the interests of other countries and heed their well-founded or groundless fears and anxieties'.¹⁵¹ Nevertheless, Germany is in a special category, and has so far been criticized much less than all the other Western powers for its policies towards the East.¹⁵²

¹⁴⁷ Andrei Zagorskii, op. cit., p. 45.

¹⁴⁸ Boris Shmelev, 'Russia and Germany', *International Affairs*, Moscow, no. 12, 1992(ii), p. 120.

¹⁴⁹ *The Daily Telegraph*, 3 February 1993, and *The International Herald Tribune*, 3 February 1993.

¹⁵⁰ *Moscow News*, no. 2, 17 January 1994.

¹⁵¹ Boris Shmelev, 1992(ii), op. cit., p. 111.

¹⁵² Heinz Timmermann, op. cit., p. 29.

1.6 The Security Dimension of the New Europe — As Seen From Russia

Although much can be achieved from closer relations between Russia and the European Union, the issue of collective security is largely beyond the EU's competence. However, security is an important issue regarding *rapprochement* between Russia and the EU, mainly because this process would not have been possible without the reduction in importance of military might, at least between Russia and Western Europe. As we shall see, another important factor is that the definition of security itself has changed in the last 10-15 years, and the EU could become a vital partner in tackling non-military aspects of security. This section also argues that the development of possible alternative security structures has allowed Russia to consider new approaches to a security equilibrium in Europe.

The very meaning of security has changed in the last decade, in Russia just as in the West. In tandem with the globalist trend described in the first section of this chapter, there has been a new emphasis on the ecological threat to European security, especially the danger of nuclear accidents.¹⁵³ Also underlined has been the menace of mass migration, and the need for a joint solution. The potential for mass migration westwards is of course linked with economic cooperation. Economic relations have become explicitly recognized as an important component of the necessary European security edifice. The greater strategic importance of economics, as the role of military power in determining international relations decreases, is now widely acknowledged. With the diametrically opposite directions taken by the economies of Europe's East and West, Iurii Gusarov has warned of the danger of the iron curtain being replaced by the 'poverty border',¹⁵⁴ which would damage yet further any chances of

¹⁵³ See for example Boris Shmelev in 'Neobkhodimost' novykh podkhodov' (a round table of specialists from IMEMO and IMEPI, on new security arrangements in Europe), *MEMO*, no. 8, 1992(i), p. 96.

¹⁵⁴ Iurii Aleksandrovich Gusarov, 'Problemy evropeiskoi bezopasnosti v sozdaniia novogo mirnogo poriadka', *MEMO*, no. 8, 1992, p. 108.

establishing an effective joint security system. Baranovskii also shared the same concern, seeing the growing polarization of European economies as one of the main threats to European security.¹⁵⁵ These areas of 'soft defence', concerning economic and ecological threats to peace, are clearly ones which can be assuaged by improved cooperation between the EU and Russia, as seen in the previous section. The more traditional security problems still remain to be solved, however.

The non-military aspects of security were most heavily emphasized around 1989-90, when the prospect of interstate war in Europe seemed particularly unlikely. This new approach to security was made possible most of all because of the improvement in relations between the USSR and its most feared potential enemy, the USA.

The early days of *perestroika* saw a phenomenon that now seems rather odd — Soviet international affairs specialists were warming to Europe, but still being hostile and competitive *vis-à-vis* the United States. This was a period when Aleksandr Iakovlev, for example, made his anti-Americanism very clear. Genrikh Trofimenko, formerly a leading analyst at the Institute of USA and Canada, said that when Gorbachev came to power in 1985, he shared Andropov's view that the USA should be kept out of Europe.¹⁵⁶ At that time, A. Grigoryants published an article which was in essence an attack on imperialists and a call on Western Europe to avoid becoming dependent upon the USA, and instead to build a stronger Europe.¹⁵⁷ Soviet Europeanists often stressed that if the relationship with Western Europe could be sufficiently developed, the partnership could survive an eventual deterioration of relations between Moscow and Washington.

It took a relatively short time, though, for Gorbachev to establish the predominant principles of his foreign policy — encouragement of détente and friendlier relationships with every country, but most of all with the USA. Europe,

¹⁵⁵ Vladimir Georgievich Baranovskii, 1992, *op. cit.*, p. 97.

¹⁵⁶ Hannes Adomeit, 'The Atlantic Alliance in Soviet and Russian Perspectives' in *Russia and Europe — an End to Confrontation?*, ed. Neil Malcolm, London, 1994, p. 38.

¹⁵⁷ A. Grigoryants, *op. cit.*, p. 87.

as a security entity, did not prove itself to be sufficiently important to dislodge the United States as Moscow's main concern. This meant that overtly anti-American visions of Europe soon lost their media space, and by 1988 there had been a complete shift in the emphasis in most specialist writing, where the USA was now welcomed to take part in the formation of a 'new Europe'. Nikolai Portugalov, not normally the most liberal of writers, stated in the summer of 1988 that

driving a wedge between the USA and Europe is an absolutely unrealistic task and one which we cannot put to ourselves. As I see it, without the USA, which will have its own 'penthouse' in the common European home, security in either Europe or in other areas is simply impossible.¹⁵⁸

This view was supported by Gorbachev himself, when he said in his speech to the Council of Europe in July 1989 that

[...] the USSR and the USA are a natural part of the European international political structure. And their participation in its evolution is not only justified but also historically conditioned. Any other approach is unjustifiable.¹⁵⁹

Such an attitude was deemed necessary partly because too great a reduction of the US forces in Europe would have made many West European states nervous and very wary of the USSR,¹⁶⁰ and also because of what Karaganov calls the 'calming European influence on US foreign and military policies'.¹⁶¹ In other words, the relationship with the USA had improved to the point where Moscow actively wanted to be joined by Washington in a new European structure, not least to avoid the creation of an exclusive West European 'Club'.

In terms of military structures in Europe, Russia has had two clear main goals: to avoid NATO coming up to the borders of the FSU in Europe, and to attempt to transfer some real decision-making power from NATO to other bodies

¹⁵⁸ *Moscow News*, no. 25, 1988, p. 6.

¹⁵⁹ Valéry Giscard d'Estaing, 'The Two Europes, East and West', *International Affairs*, London, RIIA, no. 4, 1989, pp. 653-58.

¹⁶⁰ See also Elena Volkova, 1992, *op. cit.*, p. 26.

¹⁶¹ Sergei Karaganov, *op. cit.*, p. 49.

in which Moscow holds sway, especially the CSCE/OSCE. Without such possibilities, Russia's perspective on relations with the EU would have been much more negative.

Whilst actual or associated membership of NATO became discredited as an option for Russia, there was increasing emphasis on the prospects for closer cooperation between NATO and the former Eastern Bloc, as separate entities. Hopes of such interaction being possible were raised by the creation of the North Atlantic Cooperation Council (NACC) in November 1991, establishing a forum for discussion and assistance between NATO, the then Visegrad Three, Bulgaria, Romania, the Baltic states and the CIS.¹⁶² Suggestions that NATO should use its resources to set up information centres in Eastern Europe, to provide help in the case of catastrophes, large scale migration, conversion, as well as in upholding the commitments to the Helsinki Final Act, were all discussed at the December 1991 meeting of foreign ministers of NATO and the ex-WTO. There was also the prospect of having permanent Russian representatives in NATO economic, political, and even certain military committees, as well as regular meetings of the defence ministers of all the NACC states, and yearly meetings of their foreign ministers.¹⁶³ It seemed, at that stage, that the idea of a Common Home from Vancouver to Vladivostok might become workable after all.

Cooperation between NATO and Russia has already seen concrete results. Russian senior officers started studying problems of military development in the NATO military academies in Rome and Oberammergau (Germany) with representatives of other countries in Europe, enabling them to acquire detailed knowledge of NATO military doctrine and practice, and similar courses were planned from Moscow's side, to be attended by members of all fifty-two CSCE

¹⁶² Fraser Cameron (Foreign Policy Advisor to the EC), 'The Future Relationship and Division of Responsibilities Between the EC and the CSCE' in *Redefining the CSCE — Challenges and Opportunities in the New Europe*, ed. I. M. Cuthbertson, Helsinki, 1992, p. 104.

¹⁶³ B. M. Khalosha, in 'Neobkhodimost' novykh podkhodov' (a round table of specialists from IMEMO and IMEPI, on new security arrangements in Europe), *MEMO*, no. 8, 1992, p. 100; and Elena Volkova, 1992, op. cit., p. 25.

states.¹⁶⁴ In the spring of 1994, the navies of Russia, the US and other NATO countries held joint exercises off the coast of Norway.¹⁶⁵

In fact, however, NACC turned out to be insufficient, largely because it was not offering membership, protection nor even a strategy to tackle violent conflicts in the former Eastern Bloc. The Atlantic union's next attempt at a *rapprochement* with the FSU, whilst simultaneously paving the way for East European membership of NATO, was the Partnership for Peace (P4P — see Chapter Two for more details). Russia's reaction to P4P has been very inconsistent. Despite initial objections to any implication of future membership of NATO for East European states, Moscow later acquiesced, on the condition that future membership for the Visegrad Group and others be left as a hypothetical possibility. In early March 1994, a NATO diplomatic mission in Moscow was assured by Vitalii Churkin that the decision had been taken at the highest level that Russia wanted to join P4P.¹⁶⁶ It soon became clear, though, that this agreement was seen as a way of preventing NATO expansion 'from the inside', rather than a real desire to strengthen this alliance; hence the refusal to join in on two main Partnership for Peace programmes in December 1994 (see Chapter Two).¹⁶⁷

Whether or not El'tsin's government ever expected this proposal to be accepted is a debatable question, but in any case it was refused by Washington. With Russia's growing antagonism towards NATO, this was predictable. From late 1993 the message came increasingly bluntly from Moscow that it would not accept NATO expansion into ex-WTO states; Kozyrev had said as early as February that 'East Central Europe has never ceased to be an area of interest for Russia'.¹⁶⁸ It is commonly thought that El'tsin's statement in Warsaw on the acceptability of Poland joining NATO was simply a drunken blunder; it was

¹⁶⁴ Andrei Kozyrev, 1993, op. cit., p. 3.

¹⁶⁵ *The Guardian*, 18 March 1994.

¹⁶⁶ *The Guardian*, 3 March 1994.

¹⁶⁷ *The Guardian*, 7 March 1994.

¹⁶⁸ Suzanne Crow, 'Russia Asserts its Strategic Agenda', *RFE/RL Research Report*, vol. 2. no. 50, 1993, pp. 5-6.

certainly quickly denied. The other main bone of contention between Russia and NATO had been the latter's behaviour in the Bosnian war. With Russian misgivings about sanctions against Serbia and UN no-fly zones having already grown throughout 1993, the NATO threats of bombing the Serbs around Sarajevo created an uproar in Moscow. Russian politicians of every persuasion were united in opposition to NATO bombings. Although Russian diplomatic intervention prevented NATO attacks around the Bosnian capital, the first bombing of Gorazde, despite its very restricted scale, triggered bitter criticism from El'tsin for not having been approved by Moscow; as a result he was said to be 'in no hurry' to join P4P¹⁶⁹ (it seemed clear by then that Russia would not be allowed special status).

Just as in the case of American policy on international security, NATO's attitude has exasperated Moscow because of its lack of cooperation with the rest of the world community, and the UN in particular. In the case of Bosnia, the harshness of Russian opposition to the proposed bombing of Sarajevo was due to the fact that it was based on a NATO resolution, not one of the UN; the Russian Foreign Ministry accused NATO of trying to usurp the authority of the United Nations.¹⁷⁰ When NATO fighters shot down two Serb aircraft which violated the no-fly zone and bombed a Muslim ammunition plant, Russia supported the action, as it was in response to a clear violation of a UN Security Council resolution.¹⁷¹ The case of Gorazde was different for two reasons: it was not unambiguously sanctioned by the UN mandate, as shown by efforts to justify the bombing as 'protection of UN personnel'; more importantly, the lack of consultation with Moscow caused an angry reaction. This is another reason why the Russian reaction to the prospect of NATO being the basis for the new European security system has become generally negative. In its criticism of NATO's action, it is arguable that Moscow was not simply being anti-Western, but rather pushing for a transfer of power to organizations in which it has a say.

¹⁶⁹ *The Guardian*, 12 and 13 April 1994.

¹⁷⁰ *The Guardian*, 11 February 1994.

¹⁷¹ *The Guardian*, 1 March 1994.

NATO has avoided any real shift of power from itself to the CSCE; the theoretical possibility of CSCE calling on NATO forces will be at NATO's discretion as much as in the case of the UN. The support that there had been in Russia for NACC tended to be for its role as a linking mechanism of the three main elements in the CSCE process: the North Atlantic Alliance, the European Union, and the ex-WTO. The way NATO has proceeded, however, has been entirely different. It seems clear now that any expansion of NATO will be on Washington's terms, and the resulting alliance will remain under American control. This is supported by the reaction of the American Ambassador to NATO, who said, when rejecting Russia's call for a special role in P4P, that 'we wanted to make very clear that NATO takes its own decisions'.¹⁷²

The fact that Russia finally accepted to join the Partnership for Peace in early summer of 1994 shows that El'tsin's government has retained a large degree of Westernism, despite the strong pressures from the supporters of more Eurasianist tendencies. The desire to avoid isolation from Western security structures affecting Europe was greater than the need to placate the neo-Slavophiles. What it does not prove, however, is that NATO has become an adequate foundation for an effective European security structure. Moscow's decision to join P4P does not mean that the objections listed above have been dropped; it is more likely to be an attempt to reduce the influence of P4P from inside, rather than from Russia's traditional position as an outsider.

Moscow's continued opposition to full NATO membership for the East European states brings a new perspective to the question of Russia's attitude towards EU membership for those countries. Despite what some experts have proposed,¹⁷³ however, opposition to EU membership is by no means inevitable simply because NATO membership has been countered. This is in part because membership of the EU, especially as long as common defence policy remains likely to be optional, is much less sensitive than membership of an American-led

¹⁷² *The Guardian*, 7 March 1994.

¹⁷³ See for example Suzanne Crow, *op. cit.*, p. 2.

military alliance. Equally, the Russian reaction is going to depend upon the extent to which an expanded EU is going to appear as pan-European, rather than remaining a Western phenomenon. If a free trade area with the FSU is strengthened at the same time as non-military membership is granted to East European states, the progression may well be welcomed by all concerned, especially if the EU plays a part in encouraging a pan-European approach to 'soft defence' issues (for example through the CSCE, see below). The fact that not once, at least up to the end of 1994,¹⁷⁴ has the President or the Russian government directly opposed itself to the inclusion of the Visegrad countries into the EU is extremely telling of Moscow's desire to maintain good relations with the European Union.

The lack of an adequate Western response to any Russian proposals for a truly joint security structure in Europe was one of the factors which prompted Moscow into again concentrating primarily on the FSU. Russia had never fully abandoned its military influence in most of the FSU republics, and by late 1992 that involvement in the 'Near Abroad' was again on the increase. In the words of Suzanne Crow, 'Russia's liberals underestimated the appeal within Russia's top political echelon posed by Russian nationalism';¹⁷⁵ there was a very important section of policy-makers who still had to be convinced that maintaining a conciliatory position towards the West was worthwhile. Amongst many, especially in the military sector, the feeling of persecution and of a need for buffer states was still present. This feeling was all the stronger for the impression given occasionally by Western powers that Russia would have to remain militarily alienated. The impression that Moscow is disenchanted with the West's condescending approach to international relations was confirmed by Karl-Heinz Hornhies, a senior advisor to Chancellor Kohl, who reported after meeting with senior advisors to El'tsin that 'I was told repeatedly [...] if the West wants to form

¹⁷⁴ Even by the spring of 1996, the author had not encountered any such opposition being put forward as official Russian policy; this is supported by Heinz Timmermann, *op. cit.*, p. 12.

¹⁷⁵ Suzanne Crow, *op. cit.*, p. 7.

a common security policy with Russia it must involve Moscow more closely'.¹⁷⁶ El'tsin has expressed similar frustration about relations with the EU itself, his press spokesman Viacheslav Kostikov stating during the Presidential visit to Brussels in December 1993 that

Russia considers itself to be a great power and the successor to the Soviet Union and all its might. Everybody clearly understands that Russia cannot and does not want to wait in the entrance of the hall of the 'European House' and to ask permission to enter.¹⁷⁷

To cater for this, in March 1993, El'tsin appealed to CIS leaders to improve the Commonwealth's viability as a peacekeeping organization;¹⁷⁸ and a similar call was made thirteen months later by Defence Minister Grachev.¹⁷⁹ In an address to the United Nations in September 1993, Kozyrev claimed that no other group of nations 'can replace our peacekeeping efforts' along the borders of the FSU.¹⁸⁰ By the end of 1993, there were Russian peacekeepers in Tajikistan (5,400), Moldova (1,500), Abkhazia (950), and South Ossetia (600). The Foreign Minister pointed to the successful record of Russian peacekeeping, stating that there had been no hostilities in the Dniestr region or in South Ossetia for over a year.¹⁸¹ The spring of 1994 also saw signs of Russia trying to delay the withdrawal of troops from Estonia and Latvia until after the agreed August deadline, and disagreements over the control of the Crimea and of the Black Sea fleet continued to threaten peace between Russia and Ukraine. Russia's new Military Doctrine, approved by the Security Council and by the President in November 1993, legitimized Moscow's new determination to keep troops in the

¹⁷⁶ *The Daily Telegraph*, 3 February 1993.

¹⁷⁷ Suzanne Crow, op. cit., p. 2; from ITAR-TASS, 8 December 1993.

¹⁷⁸ Suzanne Crow, op. cit., p. 4.

¹⁷⁹ *The Guardian*, 19 April 1994.

¹⁸⁰ *International Herald Tribune*, 30 September 1993; the same argument was defended at Kozyrev's speech to the Royal Institute of International Affairs, 27 October 1993.

¹⁸¹ Andrei Kozyrev, 'Russia's Peacekeeping: There are no Easy Solutions', *New Times*, no. 4, 1994, pp. 16-17.

'Near Abroad', as well as its resolve in preventing any military build-up on its borders.¹⁸²

The change in Moscow's attitude to its neighbouring states is an important one; the CIS is now going to have to be considered a regional security organization within the broader European security framework. Although it has attracted much attention in the Western press, however, Russia's recent quasi-imperialist policies do not denote a total shift away from the West. Most of the new Russian influence in the FSU has been achieved not by outright force, but by 'geopolitical manoeuvring',¹⁸³ exploiting the economic or defence weakness of its neighbours to be welcomed back. In all cases apart from Moldova, Russian peacekeeping troops were invited by the host country. The most blatant exception to the relatively controlled and responsible Russian attempts to regain influence occurred within the Federation itself. The military intervention in the Chechnian Autonomous Republic, which started in December 1994, is the low point reached, at least so far, in Russia's disregard for European Union opinion. It was caused largely by domestic pressure to stop the secessionist drive in Chechnia, not least in fear of it spreading to other areas. On the other hand, it was permitted to happen because of the level of disillusionment and dissatisfaction with the West's attempts to integrate Russia, and to help its reform process. As noted above, however, the negative EU reaction was far from ignored. The Western reaction to Chechnia will be examined in the next chapter.

In order to deal with the new security situation in the FSU and the rest of Europe, and to maximize its own role at the same time, Moscow had suggested adapting some of the UN's approaches to peacekeeping. One of the propositions has been for a greater role to be played by regional organizations, which could lighten the UN's burden by accepting responsibility for peacekeeping operations in their area, under UN auspices; predictably, the CIS was used as an example. Kozyrev

¹⁸² 'The Military Doctrine of the Russian Federation', *Jane's Intelligence Review — Special Report*, no. 1, January 1994, pp. 7-8.

¹⁸³ Suzanne Crow, *op. cit.*, p. 1.

further reiterated suggestions that the UN should link peacekeeping operations with the protection of human rights, especially those of ethnic minorities;¹⁸⁴ this proposal is likely to be linked to the desire to protect Russians in other republics, or even to use them as an excuse for intervention. The experience in Chechnia has ensured that the human rights aspect of influence of the UN, or any other international organization trying to deal within Russia, not be taken seriously for a long time to come.

Even before the Chechnian war, hopes of UN assistance were minimal. Russia had to push hard to increase the number of observers the UN was willing to send to Abkhazia from 8-12 to 80, and only 20 had arrived by the time the cease-fire was disrupted two months after the request.¹⁸⁵ If observers were hard to acquire, Russia was likely to have to look elsewhere for financial and other support for full-scale peacekeeping. In any case, the UN's stature has been badly damaged by its performance in Bosnia, both in the eyes of Russia and of the rest of Europe.

The Conference for Security and Cooperation in Europe (CSCE) has been, overall, the institution which has had by far the most Russian support as the basis for a new security structure for Europe. Partly because the Helsinki process was largely a Soviet initiative, but mostly because it is the only alternative (for Russia) to NATO and American dominance of European security, Moscow's desire to increase the CSCE's influence has been a recurring theme ever since the 1975 Helsinki Conference. Some Western specialists have even suggested that part of the reasoning for the drive for a 'Common European Home' was to rejuvenate the 'flagging' CSCE.¹⁸⁶ At the time of German reunification, there were clear links between Russian approval and suggestions of a greater role being assigned to the CSCE. The optimism about the CSCE at the end of the 1980s is only slightly

¹⁸⁴ Ibid., p. 18.

¹⁸⁵ Ibid.

¹⁸⁶ Alex Pravda, *op. cit.*, p. 5.

overemphasized by Borko and Orlov's statement: 'the "Yalta" Europe has outlived its useful life. The "Helsinki" Europe is now being born'.¹⁸⁷

There was indeed some basis for optimism, as many of the early Soviet requests for the strengthening of the CSCE were approved and put into practice. At the November 1990 CSCE summit in Paris, Shevardnadze's plan for a conflict prevention centre was agreed upon, as well as a CSCE Council of Ministers for Foreign Affairs.¹⁸⁸ Moscow had also strongly supported the opening of the CSCE Office of Democratic Institutions and Human Rights (ODIHR) in Warsaw, and the establishment of the post of High Commissioner on National Minorities.¹⁸⁹ These institutions have already shown themselves to be beneficial, especially the annual summit of CSCE Foreign Ministers; but the lack of further progress has been disappointing to Moscow. All the excitement and publicity surrounding the 1990 Paris summit of the CSCE have led to relatively little. Mitterrand's vague notion of a Confederation of Europe, first based on the EC but then progressing to the Helsinki process as its basis, was never to be attempted, despite Shevardnadze's support.¹⁹⁰ The CSCE, although having become an institution rather than a process, was still a paper tiger.

The CSCE's failings, and the lack of Western support for it, were widely acknowledged. Iurii Gusarov is one of those who recognized that many in the West do not think that the CSCE is ready for essential functions of European security. He saw a need to make the CSCE's decisions legally binding, but believed that 'so far Europe has not yet reached that level of unity, which is essential for the realization of the pan-European project'.¹⁹¹ Vladimir Baranovskii bemoaned the fact that the CSCE still works on virtually intact national sovereignty, often paralyzed by the principle of consensus, and that

187 '..."ialtinskaia" Evropa ischerpala sebia. Rozhdaetsia Evropa "khel'sinkskaia"', Iu. Borko and B. Orlov, op. cit., p. 57.

188 Anatolii Lukianov, speech at the RIIA, June 1991.

189 Konrad J. Huber, 'The CSCE and Ethnic Conflict in the East', *RFE/RL Research Report*, vol. 2, no. 31, 30 July 1993.

190 Eduard Shevardnadze, 'From Blocs to Building Blocs', *Vestnik*, April 1990, pp. 53-56.

191 Iurii Gusarov, op. cit., p. 113.

CSCE decisions are still not compulsory, Helsinki not having the mechanisms to translate its decisions into action.¹⁹²

Despite the CSCE's failings and the lack of enthusiasm from the West, Russian suggestions and enthusiasm for the Helsinki process remained. Baranovskii went on to suggest that if the right of veto was changed, and if violation of CSCE decisions resulted in heavy sanctions and potentially even in military intervention, then the CSCE could play its proper role in Europe. Gusarov, whose support for the CSCE derived partly from the fact that it is not controlled by any bloc, and grants some influence to neutral and non-aligned states, saw a clear need for a CSCE-based mutual sharing of defence, rather than the 'essential defence' of every individual country.¹⁹³

To make the prospect of a strong CSCE more feasible, there have been various suggestions of partnership. Volkova wrote that the economic support of the EC, together with tactical support from NATO, would give the Helsinki process a new impulse, and allow the resolution of many questions to be put into action. As an example, she proposed that the CSCE's Centre for the Prevention of Conflicts, if joined with the appropriate NATO institutions, could create a much more active and efficient instrument to monitor and resolve conflicts. NATO and the CSCE should also cooperate, in her opinion, to establish a system to control the sales of arms, assist in the execution of military conversion projects, and improve on the actual methods of disarmament verification.¹⁹⁴ Many became hopeful of the CSCE gaining true executive power after the December 1991 Rome Summit of NATO, when the North Atlantic alliance assured the CSCE of all the means necessary to fulfill the Helsinki Final Act and the Paris Charter, and declared that NATO was not an alternative to the CSCE process, but rather complemented it.¹⁹⁵ Although next to nothing has been

¹⁹² Vladimir Baranovskii, 1992, *op. cit.*, pp. 98-99; virtually all of the members of this round table agreed on the desirability of strengthening the CSCE's role, and the need to abolish the rule of consensus.

¹⁹³ Iurii Gusarov, *op. cit.*, p. 113.

¹⁹⁴ Elena Volkova, 1992, *op. cit.*, p. 28.

¹⁹⁵ B. M. Khalosha, *op. cit.*, p. 100.

written in Russian specialist journals about the potential role of the EU in a CSCE-based security system, Boris Shmelev has suggested that there should be permanently active sections within the CSCE which could carry out rapid and independent observance of violations of human rights, minority rights, and determine sanctions, which should be enforced by the EU.¹⁹⁶ Shmelev failed to give any details as to how the EU could impose these sanctions on the non-EU members of the CSCE, but it shows that the EU is seen as the main economic dynamo, and perhaps also trade policeman, of an eventual CSCE-led security structure.

The concept of the CSCE enabling the rest of Europe and North America to influence the resolution of the deadly conflicts in the FSU could be difficult to realize for reasons other than the obvious lack of experience, infrastructure and commitment. Yet to be tackled is also Russia's unwillingness to subordinate any of its policies concerning the 'Near Abroad'. Whenever the possibility of UN or CSCE involvement in the FSU has been officially discussed, only potential observers have been welcome, not troops.¹⁹⁷ Kozyrev, whilst appreciating the quiet support emanating from the West for Russian involvement in settling FSU conflicts, has nonetheless emphasized 'that it's a matter of support and not of attempts to instruct and control, laying the burden of fulfilling this task on Russia alone'.¹⁹⁸ However, although their presence could only have minimal impact, OSCE observers were eventually allowed into Chechnia during the conflict, and a representational office set up.

In the first years of post-Soviet Russian statehood, despite the shift to more Eurasianist policies, Kozyrev continued to show support for the CSCE. In late 1993, he talked of the need for a clear-cut 'vertical line of responsibility' for maintaining peace, from the UN and the CSCE down to NATO, NACC, the WEU and CIS; he also suggested the establishment of a permanent body for political

¹⁹⁶ Boris Shmelev, 1992(i), op. cit., p. 97.

¹⁹⁷ See for example Alexander Alexeev (Deputy Chief of the Russian Ministry of Foreign Affairs, European Security and Cooperation Department), 'Security from the Atlantic to the Urals and Beyond', *International Affairs*, Moscow, February 1993, p. 55.

¹⁹⁸ Andrei Kozyrev, 1994, op. cit., p. 18.

consultation, a Council or Committee of Permanent Representatives, as part of the CSCE structure.¹⁹⁹ In February of that year, the Foreign Minister approached 'the question of sharing (peacekeeping) burdens with our Western partners by way of CSCE mechanisms', and proposed that

in the near future, the CSCE will have to transform itself from a forum for political dialogue into an organization guaranteeing security, stability and the development of cooperation in the European space. [...] Implementation of the principles and planned programmes of the CSCE is perhaps the most important area of cooperation between the new Russia and the states united in the Atlantic Alliance.²⁰⁰

Even the 1993 Russian Military Doctrine, despite its emphasis on Russia's right to secure its interests in the FSU, declared that the deployment of foreign troops into states adjacent to Russia would be considered a military threat 'unless this is done to restore or maintain peace, in accordance with the decision of the UN Security Council or a regional agency of collective security, by agreement with the Russian Federation.'²⁰¹ In other words, there was provision for the possibility of foreign troops joining a UN or CSCE peacekeeping effort in the FSU.

The increased suspicion and antagonism which had developed by the end of 1994 prevented the CSCE Summit in Budapest achieving anything of substance; its change of name to the OSCE was unfortunately not a reflection of a change in structure or influence. The fact that most of the CSCE Summit in December 1994 was taken up by arguments over the role of NATO in Europe, and the possibility of expansion, shows that the hope for the OSCE is much less than the fear of the Atlantic Alliance.

This could simply mean that a new structure altogether will have to evolve, or at the very least a new approach. Such a new overture came just before the last CSCE Summit, when the then Foreign Minister gave a speech to the Western European Union (WEU) parliamentary assembly in which he called for close

199 Andrei Kozyrev, speech at the RIIA, 27 October 1993.

200 Andrei Kozyrev, 1993, op. cit., p. 6.

201 'The Military Doctrine of the Russian Federation', *Jane's Intelligence Review*, op. cit., p. 7.

security cooperation between the WEU and Russia. He proposed the establishment of a Russia-WEU consultative council, offered to make Russian satellite intelligence available to the WEU, to arrange joint naval operations, cooperate in defence production, and for Russia to participate in a European-wide satellite surveillance system.²⁰² It was clear, however, that this was more an attempt to weaken NATO's position than a real desire to develop mutual military dependence between the EU and Russia. However, this sort of cooperation could pave the way for meaningful interdependence, once the pendulum of relations with Western Europe has swung back towards greater trust and optimism.

What is clear is that, even in the recent times of relative distrust and antagonism, Russia wants to remain close to Europe and avoid isolation. The need for a new security structure is still being sought by Moscow. An essential aspect of this new structure, from the Russian perspective, is that it must include Russia not as a follower, but as one of the leaders. This is the principal reason why a NATO-based approach to European security cannot be the full solution; an alternative to NATO must be found to guarantee safety in Europe, lest Russia be again alienated and made fearful of the West. The United Nations's fatally indecisive performance in the Bosnian war, and the overwhelming demand for its peacekeeping resources in the rest of the world, make it unlikely to be able to provide a sufficiently reliable superstructure for European safety. Whether the necessary structure should be built on the foundations of the OSCE, as an appendage to the WEU, or from scratch, will depend on the reaction to new suggestions from the Western powers, but not least also on timing, and the domestic political situation in Russia, which largely determines the flow of official pro- or anti-Westernism.

Although this section may seem to have moved away from the EU somewhat, it was necessary to show what security avenues appeared to be open to Moscow as it sought closer relations with Western Europe overall. At the time of

²⁰² *The Guardian*, 2 December 1994.

the negotiations over the Cooperation and later the Partnership Agreements with the EC/EU, the expectation of much closer security relations with Western Europe played an essential role in Moscow allowing itself to move closer to Brussels.

1.7 Conclusions

To understand the vast changes in the Russian attitude towards Western Europe, there are many factors which must be kept in mind. One strong influence is the underlying current of feeling towards the West, which swings at inconsistent intervals and to varying degrees, between the extremes of Slavophilism and Westernism. Overall, Moscow's reaction to the EU has reflected that towards the West as a whole, with occasional exceptions caused by Russian attempts to underplay the United States' importance, or to weaken the link between Washington and the West European capitals.

Thus the cyclical history of relations with Western Europe shows that expectations of ever-improving relations were never realistic. Too many factors would push back against Westernism, once its influence had started again to predominate. This pressure came from within the Soviet or Russian government, when either the conservatives and/or the military felt they were losing too much influence. This loss of influence could be seen to happen within the governmental structure domestically, through increased Western influences within the Motherland, or as a perceived geostrategic loss abroad.

In the case of the most recent wave of Westernism, like anywhere else in the world, there is an element of 'the grass is always greener on the other side' factor — the natural tendency to be unhappy with an existing situation, and wanting to try the opposite approach. Just as countless Western governments have lost power due to popular frustration with a situation which was not

necessarily the government's fault, El'tsin's ratings have been paying the price of trying to reverse seventy years of 'Communism'.

More specifically, this rapid drift back away from a strongly pro-Western policy happened in part because many of the military and conservatives in Russia never stopped believing that the West was a threat, militarily and/or economically. Any signal which could conceivably be used to support this perceived threat was a potent weapon against the reformers.

There were two other main reasons for the premature return to widespread suspicion towards Western Europe. The first was unrealistically high expectations. After the mid-1980s, having been unreasonably negative for so long about European integration, its goals, successes and implications for the Soviet Union, Moscow went to the other extreme, being overly optimistic about the prospects of aid, joint security, and special trade privileges.

The other main reason for the growth in anti-Westernism has been the lack of provision for Russia's need of self-respect. Even at the times of greatest acquiescence in the wishes of the West, Moscow still insisted upon being treated as an equal in economic alliances, and as a leader in defence groupings. An overall impression has grown among Russian commentators that the Western powers have little intention of taking notice of the wishes of a weakened Russia; it has even been suggested that maintaining Russian frailty is intentional.

Thus partly as a result of unrealistic expectations, partly because of the West's failure to procure adequate levels of aid and support, and partly because of the failure to find a face-saving role for Russia in international politics, a very strong sense of disillusionment with the West and its promises has emerged. Even many of the more liberal politicians and specialists became more willing to support policies which could be seen as antagonistic to the West. Sergei Karaganov, by early 1994, began to support a more assertive foreign policy, 'because the country is facing a grave psychological crisis. [...] If we are to be a democratic country, then we cannot pursue a policy which would substantially depart from public sentiments.' He opposed himself to full membership of

NATO for East Europeans, arguing that this would still further increase the feeling of isolation in Russia, calling it the 'Weimar syndrome'.²⁰³ It is this disillusionment which is largely responsible for the redefining of Russia's relations with the West. It is important to re-emphasize that the recent adjustment of Russia's foreign policy represents a new perspective on what constitutes Russia's national interests, not a sudden return to self-interest after a period of surrender. The benefits of closely cooperating with the West in foreign relations and in the pace of Russian reforms were no longer seen to be sufficiently important to justify providing the conservatives with political ammunition. Both Gorbachev and El'tsin needed the West's support to achieve the stability that would enable the former to abolish the monopoly of the Communist Party, and the latter to dissolve the Soviet Union, and also to attract active assistance to propel reforms to success. The return to a more aggressive and nationalistic approach to international relations should be seen more as a result of the failure of Western support towards Russia's reforms, than as a reason for this failure.

Despite the severe disappointment on the part of both the Russian populace and their government, and despite the shrinking away from close interaction and interdependence with the EU and the West in general in the last few years, Russia has nevertheless stayed closer to Western Europe than it ever was before Gorbachev.

It has become apparent that not only the parameters within which the Great Debate is argued, but also the manner in which it is undertaken, have become more Western in character. The very fact that an antagonistic Parliament is a real problem, or that most people are more concerned with maximizing their income than with political ideals, indicate a more Western-like approach of society. The successful protection of reformist ways by the masses in August 1991 (regardless of the possibility of premeditation by El'tsin or others; the point is that people took to the streets, and believe they won) is another greatly democratizing factor

203 *Moscow News*, no. 7, 18-24 February 1994.

— there is an unprecedented feeling of empowerment amongst a very significant proportion of Russians.

The material improvement achieved by a very powerful minority is an important factor which is likely to prevent a return to strongly isolationist or command-economy policies. No less important is the freedom of choice, the predictability of availability, and the sense of equality with the West that many Russians can now feel as Russian cities have become more colourful and consumer-orientated. The freedom to travel, to work officially or unofficially, to say and read what one likes, and benefit from global communications — all of these would be fought for, if a new leadership attempted to revert to old ways.

This, and the economic reasons discussed in chapter three, explain why — despite the shift back to a more Slavophile-oriented approach to foreign policy since 1992 — relations with the EU have on the whole maintained their positive momentum. The desire on Moscow's part to avoid isolation from Europe, both in economic and security terms, remains strong. Russia has kept pushing for the signing of the Partnership Agreement, and later of the interim Trade agreement that would allow the former to be implemented. Although Russia's overall behaviour in international affairs, and the intervention in Chechnia, show that closer relations with Brussels is not the Kremlin's number one priority, the EU (and especially Germany within it) has been relatively unscathed by Russian anti-Westernism.

Relations could be improved further if a way forward towards a pan-European security structure could be agreed upon. It is clear that from Russia's point of view, such a structure would have to include it as a main partner, not as a second class member as in NACC. The OSCE could be the foundation for such a structure, but its failure to achieve much so far, or to be sufficiently respected by Moscow, could mean that a new body is needed. In any case, the domestic political situation in Russia will have to stabilize before this question is effectively approached.

In short, though the degree of Russian frustration and disappointment with the EU is high, the present movement away from the previously very close relations is only temporary. The habit created amongst ordinary Russians for a more Western style of life, the need for economic interaction with the EU, and the fear of political isolation mean that a return to previous enmity is not a realistic option. The degree of success of future relations between Moscow and Brussels depends upon the EU taking full consideration of the perceived abuse of Russia's trust, self-respect and patience.

Chapter 2: European Union Views on the New Europe and Policy Towards Russia

2.1 Introduction

This chapter will examine the various currents influencing the European Community's/European Union's approach to the Soviet Union and then Russia, from the inception of the Communities. To start with, the relative positions, and the relative weight, of the main EU member states are examined, as far as this is possible with the very limited data available. Despite the antagonism and discord sometimes present within the EC/EU, the Communities' stance *vis-à-vis* the USSR/Russia is thereafter considered a single predominant position in this chapter. The history of relations between the two sides is covered, to give an idea of the extent to which the whole approach to dialogue and cooperation has altered, and what had to change in order for the two sides to increase cooperation.

The progress of Brussels' relations with Moscow is charted, from the old-style, confrontational East-West political climate, through Gorbachev's New Political Thinking and El'tsin's new Russia, to the present-day uncertainties of how to bridge the chasm left by the collapse of the CMEA, and the already disappointed hopes of EU solidarity and support for the Russian people. The degree to which the EC was willing to compromise, and to innovate, is of particular interest. The protectionist element to the policies of the Member States is explored, together with the consequences of EC/EU restrictions on imports into its markets.

The negotiations over the Trade and the Partnership Agreements are covered in detail, especially concerning trade restrictions, the prospect of a joint free trade area, and the conditionality clause, which were the most contentious aspects of these Agreements. The resulting Agreements, and the implications of

what is decreed within them, are detailed both in order to assess the likely impact, and to determine those areas of cooperation which must still be tackled.

The question of what new security structure can replace the void left by the disappearance of the Warsaw Pact and the re-shaping of NATO is vital to the topic of relations between Russia and the EU. This is in part because until Moscow feels that there is an effective security framework in Europe which will ensure that Russia is not threatened, it cannot wholeheartedly join in a partnership with the EU, nor entirely trust the latter's member states. The security issue is also important as the EU has an important, and normally undervalued, role to play — both as an active player in 'soft defence' issues, and as a political player of enormous influence over the actions of European multinational security organizations, namely the WEU and the OSCE. The failings of the existing security situation in Europe, the possible solutions and the pros and cons for the EU's relations with Russia are all addressed in the last part of this chapter, concluding that much is still left to be done if relations between the opposite sides of Europe are to be helped rather than hindered.

2.2 Different Approaches to a United Europe

The fact that Western Europe ever managed to unite into the supranational structure which is the European Union is astonishing, for many reasons. In part, it is remarkable that this was able to happen despite the very heterogeneous approaches and perspectives of any number of issues, not least relations with Russia, as we shall see below. It is also surprising because Western Europe and its allies have always been aware of the antagonism prevalent in Moscow, until recently, towards the idea of an exclusive integration of Western Europe. Even before the end of the Second World War, European proposals for federal organization of the continent after the war were opposed by President Roosevelt, who was determined that

the basis of postwar policy must rest on a firm agreement with the Soviet Union. It was already clear that the government of the Soviet Union would look with deep suspicion on any European union, whether of a general or particular kind.¹

Yet in the years following the defeat of the Nazis, prevention of future war was the first priority, and almost anything was possible. The Marshall Plan, which in the end became directly linked with the creation of not only the EC, but also the OECD, WEU and other multinational organizations, was available to the USSR as well as to Western Europe, but for various reasons Moscow refused to join (see Chapter Four). One of the reasons was that in negotiations with Britain and France, Moscow was only willing to support the shopping-list approach, whereby each country would unilaterally deliver a list of the areas most needing aid, rather than a coordinated set of demands; this showed the determination of the Soviets to avoid any measures which would encourage integration in Europe, which would reduce the chances of weaker individual countries being influenced by Communism. Stalin had already distanced West European governments at the Moscow Conference of the Allied Council of Foreign Ministers of the Big Four (May-April 1947), and encouraged them to group against him, by demanding \$10bn in reparations as well as control over the Ruhr valley and centralization of the German state.² From then on, Europe was doomed to be split, at least for the remainder of the century.

Before going on to examine the development of the policies adopted by the EU as a whole towards Moscow, the author will very briefly summarize the main trends determining the *Ostpolitik* of the EU's most important constituent states, in order to show that 'the EU' is in fact merely a consensus of sometimes very discordant voices. The main purpose of this section, however, is to try to establish what position the individual countries support in the debate on relations with Russia,

¹ Max Beloff, *The United States and the Unity of Europe*, London, 1963, pp. 3-4; cited in Peter van Ham, 1993, op. cit., p. 18.

² Peter van Ham, 1993, op. cit., pp. 21-22.

and the influence enjoyed by major member states in pushing through their vision. Thus we can hope to grasp EU policy towards Moscow more fully, by better understanding the driving forces behind certain directions of that policy.

As explained in the last chapter, Germany's relations with Russia are of particular importance, and in the same way the German position within the EU on policy towards Russia always holds particular sway. Germany's policy towards Moscow has swung from one extreme to the other since the Community's early days. The same year that the Treaty of Rome was signed, Bonn started enforcing the Hallstein doctrine, which aimed to weaken the international status of the GDR, and discourage other countries from recognizing it. Chancellor Konrad Adenauer combined this with a *Westpolitik*, which sought to tightly interconnect Germany with the EC and the Atlantic Alliance, not least to reassure other Western countries concerning the direction of German policies. Although some claim that the erection of the Berlin Wall in 1961 triggered off the realization in West Germany that a solution to the German problem could only be found through conciliation,³ there was no clear warming of Bonn's policies until the Grand Coalition Government took up office in Bonn in 1966,⁴ followed by the election victory of the SPD's Willy Brandt in 1969. That was the year that Bonn signed the Basic Treaty and the Nuclear Non-Proliferation Treaty, followed in 1970 by the Renunciation of Force Treaty between the FRG and the USSR.⁵

Importantly, Bonn's policies towards Moscow, with the primary aim of German reunification, remained firmly couched in a multilateral framework, very often leaving the EC to attempt forging new links with Eastern Europe. Nonetheless, Germany's approach had an individual slant. The new *Ostpolitik* brought with it a new way of defining the nation-state and its importance, as shown by the popular slogan 'we should not change borders, but what borders mean'. It has been argued that such a decrease in the importance of borders was

³ Renata Fritsch-Bournazel, *L'Union Soviétique et les Allemagnes*, Paris, 1979, p. 254.

⁴ Peter van Ham, 1993, op. cit., p. 66.

⁵ Angela Stent, *From Embargo to Ostpolitik*, Cambridge, 1981, pp. 154-64; also Peter van Ham, 1993, op. cit., p. 105.

sought by the Federal Republic not only to increase links with Eastern Germany, but also to re-establish a new version of *Mitteleuropa*, where Germany could enjoy special relations with Central and East European states, as has historically been the case.⁶ In fact, although special conditions applied for relations between the two Germanies, Bonn's use of the EC to reach its foreign policy goals meant that the relations with all other states had to become increasingly well-defined and compatible with those of other EC states, rather than nebulous and less relevant. The apprehension among other EC states about Germany's power and influence has also worked against the possible development of a *Mitteleuropa*.

Bonn's desire to reunite Europe, initially as a way of achieving German reunification, has been clear ever since Brandt's *Ostpolitik*. Even though the slant towards cooperation and integration is more typical of the SPD (Social Democratic Party), the West German government was supporting ideas of a common Europe even after the SPD had lost power, and yet before Gorbachev had proven his willingness to compromise fully with the FRG. Thus, for example, Foreign Minister Genscher talked of a 'European Identity', saying that the USSR 'according to its history and the cultural contribution of its peoples', is a full member of this wider Europe, and that this is why West Germany favoured overcoming the division of Europe. The German Federal President added in 1987 that 'Politically, Europe is divided, but it is undivided and indivisible in spirit'.⁷ This was a very general principle, however, and suspicion of the USSR's motives when talking of the 'Common European Home' remained strong until reunification was allowed to take place. Then still Defence Minister, Wörner warned in November 1987 that there was a correlation between the 'huge military weight of the superpower USSR' and its intention of 'clear political dominance in peace', and terms such as 'common security' or 'Common European Home' were

⁶ Ole Waever, op. cit., pp. 477-93.

⁷ Carl-Christoph Schweitzer, 'The Federal Republic of Germany in the 1980s' in *The Changing Western Analysis of the Soviet Threat*, ed. Carl-Christoph Schweitzer, London, 1990, p. 250.

merely aimed at disguising this looming dominance.⁸ This position, however, was fairly average for the EC.

After Moscow finally agreed to German reunification, despite the fact that it had already achieved its main aim, Bonn responded with a great deal of support for the USSR, and later Russia. Chancellor Kohl pushed energetically for Russia to be admitted in the G7, allowing the political G8 to be established. Most importantly with regards to this chapter, Germany was also the strongest proponent of compromise and speedy signing of the Partnership and Cooperation Agreement; as described below, Germany was even pushing hard for precisely defined parameters which would determine whether or not a free trade area between Russia and the EU could be established after 1998.⁹ Germany had also managed to obtain greater trade concessions for Russia within the Agreement. This approach is typical of Bonn's constant efforts to show a Western willingness to compromise, and to treat Russia as similarly to the Central European countries as possible;¹⁰ this is the position not only of the CDU, but was confirmed as the position of the opposition SPD in 1995 as well.¹¹

As can be seen from this strong (although by no means unconditional) German support for Russia within the EU, Bonn clearly also sees itself having a 'special relationship' with Moscow, this exact term being used by the German Ambassador to Moscow in an article in *Moscow News* in December 1993. One of many examples of this was when El'tsin spoke first with Kohl, to confer on NATO's ultimatum on Sarajevo, before speaking with Clinton.¹² The greater degree of closeness, especially on the issue of how to integrate Europe's East and West, is of course not surprising. Russia and Germany are, after all, the two large powers with most to gain or to lose over how Eastern Europe is dealt with in this period of transformation. This 'special relationship', however, has not been

⁸ Ibid., p. 255.

⁹ Heinz Timmermann, op. cit., p. 28.

¹⁰ Ibid., p. 12.

¹¹ *The Guardian*, 17 November 1995.

¹² Peter Shearman, 'Russian Policy Toward Western Europe: the German Axis' in *Russian Foreign Policy Since 1990*, ed. Peter Shearman, Boulder, 1995(ii), pp. 98-99.

enough for Germany to support the conversion of the CSCE into a body with real decision-making powers over security in Europe; Bonn balked at this, just as did the majority of EU member states, although the German Ambassador to Hungary did say at the October 1994 Budapest Conference that 'we can build up the CSCE on condition that no member state gain a special status or particular right in any part of the CSCE zone'.¹³ Neither has it been sufficient for Germany to denounce plans of eventual integration of the Visegrad states into NATO. However, whilst Germany is principally supportive of the expansion eastwards of NATO, it is also pushing for the concept of 'cooperation and integration' with regard to the whole of Europe, including Russia; in this case, this would mean including Central Europe into NATO, but also introducing Russia into a looser European security organization¹⁴ (or presumably strengthening the role of the OSCE, although not to the extent requested by Russia in late 1994). Bonn's support of Russia obviously has its limits; in January 1995, for example, the German Parliament passed an all-Party resolution stating that whilst Germany would remain a 'partner and friend' of Russia, it maintained trust in its democratic process, as would the EU and NATO, but if Russia was to continue forceful interventions in the ex-USSR, relations between Germany and Russia would deteriorate.¹⁵

Economically, Germany will remain at the forefront of West European states in trade with Russia. One estimate values German assistance to the USSR/Russia at \$50bn;¹⁶ the flow of assistance has considerably lessened since 1993, and it will remain at a more modest level now that the repatriation of Russian troops from Germany has been completed, and that the macroeconomic implications of reunification are politically sensitive. Politically, however, Germany will have to tread very carefully, not least because of Moscow's record for forming liaisons with Germany rather than the rest of Europe (such as the Rapallo Treaty of 1922, and the Molotov-Ribbentrop Pact of 1939), echoes of

¹³ Michael Mihalka, 'Restructuring European Security', *Transition*, OMRI, 30 June 1995, p. 6.

¹⁴ Heinz Timmermann, *op. cit.*, p. 14.

¹⁵ *Ibid.*, p. 14.

¹⁶ Peter Shearman, 1995(ii), *op. cit.*, p. 97.

which have been heard recently in Russia, as noted in the first chapter. Yet it is not just EU concerns over the development of any exclusively close relations between Russia and Germany which will restrain the latter's policies. Bonn would in any case be very unlikely to forego what many consider the securement of its new buffer zone, as many consider the inclusion of the Visegrad countries into the EU,¹⁷ even if this meant a new coldness coming over the Bonn-Moscow axis. Germany clearly no longer wants to be the Eastern frontier of Western Europe.

To understand France's attitude towards the EU's *Ostpolitik*, it is helpful to understand the complete transformation through which France's attitude towards the unity of the EC itself has gone. Under the leadership of General de Gaulle almost since the establishment of the European Communities, Paris jealously guarded full sovereignty of nation-states within the Community, under the slogan 'Europe des patries'; this was also the policy which prevented the creation of the European Defence Community, and which took French troops away from NATO control during peacetime. The *volte-face* occurred in the early 1980's, when French politicians started trying to make the EC as state-like as possible, both with a defence capacity and a cultural 'mission'; in the words of Ole Waever, 'France had become too small, and its mission had to be taken over by "Europe"'.¹⁸ Waever argues that this Europe could only include Western Europe, as only Western Europe could have the necessary cohesion. Another suggested reason why France has been inclined to support the exclusion of Eastern Europe from the EC was the desire to avoid the increase in German power and influence expected if the Community continued to grow eastwards,¹⁹ and arguably also to avoid the reduction in relative influence which would result from the greater number of seats in the Council and Parliament, if expansion occurred. This coldness clearly extended to the USSR, even after Gorbachev had

¹⁷ Kirill Sergeevich Viatkin, 'Rossiia i Germaniia: potentsial sotrudnichestva', *MEMO*, no. 4, 1994, p. 106.

¹⁸ Ole Waever, *op. cit.*, pp. 477-93.

¹⁹ Peter van Ham, 1993, *op. cit.*, p. 107.

been in power for some time. Pierre Hassner believes that under the term 'Common European Home' used by Gorbachev, the Quai d'Orsay saw the old Russian aims of denuclearizing Germany and weakening European links with the USA. France feared that by jumping head-first into Gorbachev's conception of Europe, the French perspective of how the EC should be developing — in particular the development of a European defence capability and re-enforcement of German ties with its Western European partners — could be put at risk.²⁰

That is not to say that France has not attempted to build structures which would draw Russians nearer to their Western neighbours. The European Bank of Reconstruction and Development (EBRD) is arguably an example of the French 'missionary' approach to Europe. Contrarily to the British Prime Minister John Major, for example, who used the inauguration of the European Bank to try to sell London to the business world, both President Mitterrand and former President of the EBRD Jacques Attali had a visionary approach to the bank, arguing it will be the 'first institution of the new world order with both a "political and economic mandate"'.²¹ The goals of the EBRD, as explained in Chapter Four, are much more humble than those of 'European Home builders', but at least they were being executed eighteen months after their conception in Paris. Paris also clearly came to put more trust in Gorbachev and his New Political Thinking, with Mitterrand for example saying that he approved of Gorbachev 'a hundred times' for his initiatives, especially on disarmament.²² Another French overture was President Mitterrand's vision of a 'European confederation', discussed in the first chapter. Although this has been seen by some as a breakthrough in the design of a new Europe, others believe it is simply another mechanism to avoid the need to include East European states in the Community. It does seem clear that France's priorities are increased integration

²⁰ Pierre Hassner, 'Perception of the Soviet Threat in the 1950s and the 1980s: the Case of France' in *The Changing Western Analysis of the Soviet Threat*, ed. Carl-Christoph Schweitzer, London, 1990(ii), p. 183.

²¹ *The Guardian*, 16 April 1991.

²² Pierre Hassner, 1990(ii), op. cit., p. 183.

of the EU, preferably with a degree of military capacity,²³ and the resulting containment of German power.

Another element of French policy within the EU is its opposition to reduction of aid granted to many of its former colonies, and when it appears that assistance to France's partners in Africa is reduced as a result of the relatively high levels of aid being aimed at the FSU, France is likely to argue against any such reduction in EU leverage in LDCs. Paris also often shows a strong Mediterranean streak in its attitude to the EU's Russian policy; as mentioned below, France is not above trying to protect its agricultural and other products from Russian imports, and has been opposed to widening the scope of the European Investment Bank's activities to the USSR/Russia. Another example of France using the EU to protect its own market share is Paris' strong opposition to the freeing of quantitative restrictions on the importation of Russian enriched uranium into the Union.²⁴ Nonetheless, the Élysée Palace's tradition for high diplomacy, and the desire for France to achieve a historic mission through the EU, mean that French policies will continue to seek a strong European Union role in the restructuring of the former Soviet Bloc. This does not mean, of course, that the role of the EU as seen by Paris will be mirrored in other European capitals; the opposite was true as France started its presidency of the EU at the same time as the war began in Chechnia. Paris' reaction was soon much harsher than that of London or Bonn, pushing harder for official EU responses, and calling for sanctions.²⁵ Inevitably, Russia will remain on a very different level from core EU countries in the new Europe as viewed by Paris.

The other major EU power, Great Britain, has been no exception to the general rule of varying approaches to the Kremlin. Britain has often tried to resuscitate its traditional leading role in international diplomacy through its *Ostpolitik*, and very often to the despair of other West European countries; for

²³ Dominique David, *Conflits, puissances et stratégies en Europe — le dégel d'un continent*, Brussels, 1992, p. 12.

²⁴ Peter Shearman, 1995(ii), op. cit., p. 104.

²⁵ *The Guardian*, 11 January 1995.

example during Prime Minister Harold MacMillan's quest for a compromise over Berlin in 1959-62, or Wilson's declaration that London was ready to recognize the Oder-Neisse line in 1964.²⁶ In the run-up to Britain's accession to EC membership, on the other hand, British policy made very sure it did not strongly displease any of its future partners, especially Germany, whose support was essential if Britain was to be accepted into the Community. Once a member of the EC, however, London could again allow its strong Atlanticism to prevail. In 1981-82, Margaret Thatcher showed far less determination than France and Germany to defeat American sanctions on exports to the USSR. London's primary concern was still to avoid financing the incompetence of the Soviet system, and thus at an EPC meeting of the Twelve foreign ministers in 1988 she joined Portugal in favouring a much more passive EC policy towards the East than was proposed by Germany and France.²⁷ At about the same time, the Foreign Minister Sir Geoffrey Howe urged 'a better European defence effort, galvanized perhaps through the WEU'.²⁸

The British Government's stance altered markedly from 1989. This was in part due to a greater confidence that the Russian reforms were not merely artificial or transitory, but also clearly due to the fact that keeping the EC open to Eastern Europe had been identified as a subtle yet effective mechanism with which to slow down the process of integration amongst the Twelve;²⁹ this reasoning is also likely to have encouraged British support for accession of the EFTA states. John Major carried on the pro-Eastern Europe stance with regard not only to the EC, but also using his chairmanship of the G7 during the August 1991 *coup* aftermath to initiate a strengthened Western aid package to the USSR.³⁰ Just before taking up his presidency of the European Council, John

²⁶ Peter van Ham, 1993, op. cit., p. 107.

²⁷ *Time*, 14 November 1988.

²⁸ Julian Bullard, 'Perceptions of the Soviet Threat: Britain in the 1980s' in *The Changing Western Analysis of the Soviet Threat*, ed. Carl-Christoph Schweitzer, London, 1990, p. 147; Sir Geoffrey said this in Brussels in March 1987.

²⁹ Anna Michalski and Helen Wallace, *The European Community: the Challenge of Enlargement*, RIIA, London, second edition, 1992, p. 11.

³⁰ *The Guardian*, 30 August 1991.

Major affirmed that 'the borders of Europe do not stop in the centre of our continent. We must not replace the iron curtain that has been torn down with a new regulatory net'.³¹ Helen Wallace and Anna Michalski note that '[...] some voices can be heard, especially from London, suggesting that the next group of candidates — two or three or four — could be accommodated within the existing structures and then take part in the next IGC (Inter-Governmental Conference)',³² which will be in 1995-96. This shows either great optimism, or, more likely, great determination to avoid fulfilling the goals of Maastricht.

Italy's role, although less important than that of Europe's three largest countries, has nonetheless been one of continued support and involvement in Russia. The vanguard role that Italy's national gas company played in breaking down an unofficial boycott of Russian hydrocarbons in 1960 (see Chapter Three), and Fiat's massive deal to establish the Lada car plant at Togliattigrad, were merely the two largest projects in a general Italian policy of encouragement of trade with Russia which has continued into the 1990s. It is therefore not surprising that it was an Italian industrialist, Carlo de Benedetti, who first presented a serious proposal for a 'Marshall Plan' for Eastern Europe, in the spring of 1988 (see Chapter Four). In 1992, according to *MEMO*, Italy was second only to Germany in trade with Russia, and also second in volumes of inter-governmental credits being offered. Although Italy was at first opposed to granting significant financial aid to the USSR and Eastern Europe by the G7, she had changed her mind by the time of the Houston G7 summit, the reversal in policy having occurred due to apprehension about the extra influence Germany would gain if its assistance to Eastern Europe was not channeled through the G7 and the EC. Rome requested that the G7's assistance be granted according to the principles established by the EC at the Dublin Summit in June 1990. Thus Italy showed herself in favour of a consolidation of the EC as the best way of helping the USSR without damaging relations within Western Europe.³³

³¹ *The Guardian*, 29 April 1992.

³² Anna Michalski and Helen Wallace, op. cit., p. 14.

³³ Nadezhda Arbatova, 'Rossiia i Italiia: neispol'zovannyi potentsial', *MEMO*, no. 5, 1993, p. 65.

The Southern members of the EU are also worth mentioning in the context of relations with the former Soviet Bloc, as they have a strong tendency to oppose moves which would increase the accessibility of the EU market to East European goods, which are often in competition with South European production, especially in agricultural products and textiles. Together with France, they have also tended to oppose granting Russia access to European Investment Bank (EIB) credits.³⁴ Paradoxically, however, it appears that public opinion in Greece, Portugal and Spain is the most pro-Russian of the EU. In a poll conducted by Eurobarometer in the autumn of 1992, Europeans were asked which country they thought should be part of the EU by the year 2000. On the prospect of Russian membership the average answers for the Union as a whole, after being weighted, were 39% for and 43% against. All three Southern members averaged 48% for Russia's inclusion, however, and Spain only had 27% voting against,³⁵ suggesting that opposition from the Southern capitals to freeing trade with Russia may not be as inevitable as is sometimes suggested.

2.3 Agreement and Disagreement Between Brussels and Moscow, Before Gorbachev

Out of the often contradictory tendencies of the member countries, the European Community *per se* managed to put forward a mostly consistent, and eventually successful, policy for the establishment of diplomatic relations and closer economic cooperation between the USSR and the EC. Despite the extremely hostile attitude of the Soviet Union towards the Community in the 1950s and 1960s, as we saw in Chapter One, Brussels regularly reminded the Kremlin that it was willing to be cooperative. One example occurred in 1963, when an EC *aide-*

³⁴ Perdita Fraser, 1994, *op. cit.*, p. 210.

³⁵ *Eurobarometer*, no. 38, December 1992, p. A46; samples were taken between 21 September and 15 October 1992, using 1000 people, representative of the population as a whole, from each member state (with the exception of 300 additional for Northern Ireland, only 500 for Luxembourg, and an additional 1000 for East Germany).

mémoire was sent to the USSR expressing hope that relations could be normalized,³⁶ accompanied in the same year by the so-called '*dolce vita* concessions' on imports of goods including vodka, caviar and crab-meat.

It is doubtful that these advances played any great role in the relatively lenient position of Moscow *vis-à-vis* its East European allies, but in any case in the late 1950s and 1960s certain CMEA countries defied the unwritten Soviet law forbidding Eastern Bloc countries from having any dealings with the EC, when they asked for 'alleviation of some problems of agricultural trade'³⁷. The resulting agreements were extremely limited, however. Another EC initiative was taken when in 1972 the heads of state and government of the Community expressed their willingness to establish trade relations with Eastern Europe as a result of improved East-West relations. This was followed in 1974 with an EC offer to establish bilateral agreements with every Central and East European country, in view of the introduction of a Common Commercial Policy (CCP).³⁸ Brussels was to find it difficult to enforce a common commercial stance with respect to the Soviet Bloc. The Council of Ministers had decided in late 1969 to unify trade policy *vis-à-vis* Eastern Europe, theoretically disallowing bilateral trade agreements from remaining in force beyond 1974. In fact, however, not only did many bilateral trade agreements continue to operate beyond 1974, but the very importance of trade agreements was reduced in favour of accords which could be initiated and controlled by national governments. The usual formula was to sign economic cooperation agreements, which dealt with credit agreements and political support for joint ventures rather than 'trade' itself, thus escaping Brussels' control. Even when these agreements did have a trade element,

³⁶ 'EC-USSR Relations', Commission of the European Communities' Background Report, 5 April 1990.

³⁷ John Pinder, 'The EC and Eastern Europe Under Gorbachev: How Normal Could Relations Become?' in *The Economies of Eastern Europe Under Gorbachev's Influence. NATO Colloquium, March 1988*, Brussels, 1988, p. 266.

³⁸ 'EC-USSR Relations', Commission of the European Communities' Background Report, 5 April 1990.

however, there was little the EC could do to prevent this practice, as there was no consensus on this issue.³⁹

On the question of credit to the CMEA states in particular, there had been an attempt by the EEC to coordinate policy as early as 1962, when the Council ruled that any credits over a term longer than five years (thus exceeding the limit established by the Berne Union of Credit Insurers in 1934) would have to be approved by Brussels. This too was often being ignored, however, as member states wanted to compete with non-EEC soft loans being offered to the East. All the major EEC players had their credit support agencies actively supporting their own businesses, with only the FRG very reluctant to see larger flows of credit going Eastwards, lest the GDR benefit from it. An important precedent in the battle between Brussels and the national capitals on control of trade and credits to the East was France's successful defence in 1966 of credits as a part of national foreign policy, and therefore not under the jurisdiction of the EEC. From the end of the 1960s the Community tried to put the European Investment Bank in charge of member states' export credits, but the high demand for new Western technology in Eastern Europe, the general atmosphere of *détente*, the specially low interest rates for credit to the East (2-7%, whilst domestic borrowers could be charged as much as 14%), and the flood of oil crisis petrodollars coming through commercial banks meant that the flow of credits to Eastern Europe was much too large and diverse to be managed by a new institution which had limited support.⁴⁰ Not until the 1975 Helsinki Conference did the EC states begin to coordinate their credit policies more effectively, helped later by the 1976 'OECD consensus', strengthened in 1978, which imposed guidelines on government-backed credits stretching over two years.⁴¹ Thus the EC failed to increase the pressure upon CMEA states to recognize it and sign trade agreements through a coordinated credit policy. By the end of the 1970s, however, the damaging competition in Western credit terms to the East was minimized by the G24. The EC could

³⁹ Peter van Ham, 1993, op. cit., pp. 89-91.

⁴⁰ Ibid., pp. 80-85.

⁴¹ Marie Lavigne, op. cit., pp. 209-12.

finally be perceived as having a more unified trade policy towards the USSR, although there was much progress yet to achieve.

The CCP towards the Soviet Bloc was part of the run-up to the Conference on Security and Cooperation in Europe. From the onset, the CSCE negotiations were attractive for the EC as a test of the European Political Cooperation (EPC) machinery.⁴² In preparation for the CSCE, a 'Groupe *ad hoc* CSCE' was formed, in early 1971, to prepare a common stance on economic issues, and a similar 'Sous-Comité CSCE' was established within EPC, although in the latter there was no Commission representative, as political involvement was still considered forbidden for the EC. In the end, there were many issues in the 'Second Basket' (on cooperation in economics, science, technology and the environment) which were settled purely between the EC and the USSR, largely because the USA was far from cooperative in East-West trade. Although it covered general concepts rather than concrete measures, the final resolution for the Second Basket was almost entirely based on a draft drawn by the Commission. So successful were the EC states at achieving a unified stance that the EC, rather than NATO as had been expected, took the lead in coordinating the groundwork for the CSCE. Determined to see a successful outcome to the Helsinki Conference, Moscow did not object to the Italian Prime Minister Aldo Moro signing the Treaty on behalf of the EC as well as his country. Very regular meetings of the Working Group of CSCE experts of the EC members helped the EC to retain a common stance in the CSCE Follow-up Meetings in Belgrade (1977-78) and Madrid (1980-83). By the Madrid meetings, the Eastern Bloc countries no longer raised objections to delegates speaking on behalf of the EC.⁴³ Thus *de facto* recognition of the EC as an international actor was achieved through the CSCE process starting in the mid-1970s, although it was to be officially denied for another decade.

⁴² Fraser Cameron (Foreign Policy Advisor to the EC), 'The Future Relationship and Division of Responsibilities Between the EC and the CSCE' in *Redefining the CSCE — Challenges and Opportunities in the New Europe*, ed. I. M. Cuthbertson, Helsinki, 1992, pp. 95-96.

⁴³ Peter van Ham, 1993, op. cit., pp. 111-13.

Another sign of thawing relations between the CMEA and EC came in 1976, with a Soviet proposal (through the CMEA Executive Council) for an agreement to be concluded between the EC and the CMEA, and between their respective member countries. This agreement was to be almost totally 'bloc-to-bloc', and would have severely limited the possibility for bilateral contacts, as they would have had to be approved by a special body — the 'EEC-COMECON Joint Committee'. This was seen as an attempt to appease Moscow's East European allies, whilst not risking a surrender of influence in individual countries to the EEC; in fact, this agreement would have strengthened the CMEA, thus benefiting the USSR.⁴⁴ The CMEA proposal also called for the elimination of quantitative restrictions in agriculture and trade, *inter alia* implying the abandonment of the Common Agricultural Policy, but the EC's objections were of a more basic nature. Brussels considered any increase in the USSR's control over its East European allies, through the CMEA, as wholly undesirable. Furthermore, it could argue that the international legal status of the EC and the CMEA were incompatible; whilst the Treaty of Rome gave the EEC both treaty-making power and diplomatic status in international relations, the CMEA Charter only mentions its intergovernmental character, and was considered by the European Parliament to be 'only empowered to issue recommendations and these only assume legal force when adopted by other countries', and having 'no legal powers whatsoever to impose the implementation of such an agreement on its members'.⁴⁵ The Commission had its own reasons for rebuffing the draft agreement, as it implied a reduction in its influence and a shift back towards empowerment of the Council of Ministers and the individual EC states. As a result, no trade issues were accepted in these negotiations with Comecon, and deliberations on statistics, standards and the environment were not backed by sufficient political will from the EC's side to be successful. Talks were abandoned with the advent of the Afghan crisis.⁴⁶

⁴⁴ 'The European Community and Eastern Europe', lecture given by Sir Leslie Fielding, *op. cit.*

⁴⁵ Peter van Ham, 1993, *op. cit.*, pp. 129, 52 and 135.

⁴⁶ John Pinder, *The European Community and Eastern Europe*, New York, 1991, p. 13.

Meanwhile, despite disagreements and set-backs, homogeneity of the EC's domestic and foreign trade policies was gradually increasing. For example, the forthcoming transfer of the Twelve's fisheries' policy to EC control forced the first meeting for negotiations between a Soviet Minister (of Fisheries) and the Commission in February 1976. Moscow had to either negotiate fishing quotas, or leave EC waters; there was no chance of weakening EC solidarity by ignoring Brussels this time. The Soviet Minister of Fisheries did state, however, that his mandate was to reach agreements with the EC's member states, and not with the Community itself; the Soviet delegation also kept requesting that there be special EC-CMEA negotiations. In the end, the talks failed to reach agreement, and Soviet ships had to leave EC waters.⁴⁷ The fact nevertheless remains that the EC's strong commercial policy had forced the USSR to the negotiating table. Despite the failure to reach agreement in this instance, Brussels was beginning to realise that it had the upper hand, as EC-USSR trade relations had become much more important to Moscow than they were to the Community (for figures, see Chapter Three). The few attempts by Moscow to reach an EC-CMEA agreement, in the late 1970s and early 1980s, had little new to offer; the EC could afford to wait for its own terms to be met.

2.4 The EC's Relations with the USSR under Gorbachev

With Gorbachev in charge in the Kremlin, a new initiative to establish ties with the EC was put forward in May 1985 by V. Sytchov, the new Secretary General of the CMEA. This proposal was devoid of many of the obstacles previously retained by Comecon and, most importantly, allowed some state trade relations between the EC and individual CMEA states. The extent to which this was guaranteed, however, was ambiguous, and the draft agreement was still basically

⁴⁷ Peter Marsh, 'The Development of Relations Between the EEC and the CMEA' in *The EEC and Eastern Europe*, eds Avi Shlaim and G. N. Yannopoulos, Cambridge, 1978, p. 61; and Peter van Ham, *op. cit.*, p. 132.

an inter-bloc one, and thus unacceptable to Brussels. The real breakthrough came in September of that year, when Sytchov declared that an EC-CMEA agreement could be secured 'within the respective fields of competence' of the two organizations, thus clearing the way for an arrangement where Comecon was not an equal.⁴⁸ The combined pressure of Eastern Europe's attraction to the EC, and of Moscow's need for improved trade relations in order to acquire technology, created a very fertile environment for agreement.

Negotiations began in February 1986 between the CMEA and the EC, and after the sticking point of West Berlin's status was resolved largely in Brussels' favour, the Joint Declaration was signed on 25 June 1988. The Declaration did not cover trade relations; it merely established official relations between the EC and Comecon, and provided for cooperation between them on matters of mutual interest, as well as for future agreement on the nature of such cooperation.⁴⁹ It was most of all a token gesture, not least because the CMEA had by this stage lost most of its influence. Nonetheless, it was a very clear sign of the revolutionary transformation taking place in Eastern Europe, moving away from Soviet imperialism, and reflecting a strong West European Community together with the crystallization of EC foreign policy. Negotiations began with all the individual European CMEA states towards Trade and Cooperation Agreements with the EC.

Without the political limitations of previous Soviet regimes, it did not take long at all for Gorbachev's government to show the strong economic interest it had in becoming closer to the EC. The first Soviet Ambassador to the Communities, having presented his credentials in March 1989, started negotiations in June with the Commission. It only took three rounds of negotiations before the Trade and Cooperation Agreement between the EC and the USSR was signed in Brussels on 18 December 1989. This agreement was very similar to those signed with Hungary and Poland, except that in the USSR's

⁴⁸ Peter van Ham, 1993, *op. cit.*, pp. 141-43.

⁴⁹ John Pinder, 1991, *op. cit.*, p. 25.

case Euratom also joined the agreement, due to mutual interest in nuclear research and safety. The agreement was a ten-year one, whereby the EC abolished Quantitative Restrictions (QRs) on Soviet imports, subject to exceptions for sensitive products (including steel, textiles and agricultural products), and the USSR granted non-discriminatory treatment for Community exports as regards QRs, licensing and the allocation of currency. The quotas specific to state-trading countries were to be curtailed, gradually, and abandoned totally by 1995. For all goods not exempted, the principle of Most Favoured Nation (MFN) applied. The agreement also promised to facilitate the operations of Community businessmen in the Soviet Union. Furthermore, economic cooperation was promised in a wide range of areas: environment, energy, transport, science and technology, financial services, and others.⁵⁰ A joint committee, meeting annually, was also established to oversee the agreement and act as a forum to increase dialogue and cooperation between the EC and the USSR.⁵¹

The signing of this agreement had significant diplomatic and political importance, but regarding concrete terms of trade improvements or cooperation objectives, its achievements were modest. The document did not provide for any financial commitment on the part of the EC, even in the areas of cooperation. On the trade issues, in practice the EC was already according MFN status to Russian goods not covered by the ECSC, CAP or Multi-Fibre Arrangement. As explained in Chapter Four, hydrocarbons were not affected by EC trade restrictions, and raw materials were subject only to low or non-existent tariffs, and few quotas.⁵² Most importantly, the EC retained safeguards against imports which, according to GATT rules, 'cause or threaten serious injury' to domestic producers.⁵³ It has been argued that this type of safeguard clause in agreements can be even more

⁵⁰ 'EC-USSR Relations', Commission of the European Communities' Background Report, 5 April 1990.

⁵¹ Perdita Fraser, 1994, *op. cit.*, p. 200.

⁵² Peter van Ham, 1993, *op. cit.*, p. 86.

⁵³ John Pinder, 1991, *op. cit.*, pp. 25-28.

restrictive than normal anti-dumping, which could also still be enacted.⁵⁴ The reason for this is that rather than having to prove that the price of imports from the USSR is lower than an appropriate equivalent, with the safeguard clause the EC producers simply had to show that these imports were 'damaging'. In the case of state trading countries such as the USSR, inflicting anti-dumping duties had already been made relatively easy, as any underpricing was judged in relation to prices from a 'free market' equivalent. To cite one example, in September 1993 Russia was subjected to a temporary anti-dumping duty of 120ECU per tonne on its exports to the EU of isobutanol; the 'analogous' country chosen to determine the 'fair' price was the USA, as Brazil (chosen by the complainant) and Poland (by then no longer considered state-trading, and suggested by Russia) were not deemed acceptable by the Commission as they were monopolies which enjoyed some tariff protection.⁵⁵ Thus in this and many other cases, the dumping margin (the difference between the suggested import price and the imposed minimum, once anti-dumping duty is added⁵⁶) was much greater than it should have been, considering the lower labour costs in Russia. Yet the 'safeguard clause' makes protectionism easier still in the Trade and Cooperation Agreement, as it can provide safeguards against almost any increase in imports from Central and Eastern Europe which could be considered as harmful to EC producers.

The number of goods subjected to anti-dumping is small. Between 1985 and 1989, for example, the USSR had anti-dumping procedures initiated against it over exports to the EC only in the following instances: for deep freezers (in 1985), ferro-silicon (1986), urea and polyester fibre (1987) and calcium metal

⁵⁴ J. M. C. Rollo and Helen Wallace, 'New Patterns of Partnership', in *The Community and the Emerging European Democracies*, a Joint Policy Report of six national EC foreign policy research institutes, June 1991, p. 60.

⁵⁵ *Official Journal of the European Communities*, no. L 246, 2 October 1993, 'Commission Regulation (EEC) no. 2720/93 of 28 September 1993, imposing a provisional anti-dumping duty on imports of isobutanol originating in the Russian Federation'. Isobutanol is a neutral liquid, mainly used as a solvent in paint and laquer industry; also used as a plasticizer and as a raw material for the production of acrylates.

⁵⁶ Brian Hindley, 'Exports from Eastern and Central Europe and Contingent Protection' in *Trade, Payments and Adjustments in Central and Eastern Europe*, eds John Flemming and J. M. C. Rollo, RIIA and the EBRD, London, 1992, p. 146.

(1988).⁵⁷ During the 1992-93 period, the only new anti-dumping duties imposed upon Russia were regarding potassium chloride, isobutanol and low carbon ferro-chrome.⁵⁸ This does not mean, however, that anti-dumping laws have not done much damage to Soviet and Russian exports; the knowledge that threatened EC producers can initiate anti-dumping procedures leads to massive voluntary restriction of exports. The number of goods affected by quantitative restrictions is much larger. In 1992, a total of 1,058 QRs were still being imposed on Russia on a transitional basis, although less than 10% of these were enforced by more than two member states. Therefore, these QRs often did not prevent imports from reaching their desired destination, merely forcing them to be imported first into another member state; they do represent an administrative and logistical barrier, however.⁵⁹ It was wholly unclear how many of these QRs were to be abolished by 1995, as specified in the agreement, and how many would be retained on account of their 'sensitive' classification.

2.5 The Evolution of a New Partnership Agreement

The above shortcomings, and the fact that Poland, Czechoslovakia and Hungary were already in negotiations for Europe Agreements to replace their Trade Agreements, meant that Brussels quickly came to accept that the Trade and Cooperation Agreement with the USSR was also insufficient. The EC was sensitive to Russia's dissatisfaction, and ready to accommodate Moscow through a new form of agreement. Within the West European side, it was the French and German governments which first put forward initiatives to start negotiations for a new agreement, proposing both wide-ranging cooperation measures and gradual

⁵⁷ Susan Nello, *The New Europe: Changing Economic Relations between East And West*, London, 1991, p. 52.

⁵⁸ Regulation (EEC) no. 1031/92, and in *Official Journal of the European Communities*, no. L 246, 2 October 1993, 'Commission Regulation (EEC) no. 2720/93, and 'Council Regulation (EEC) no. 2717/93, respectively.

⁵⁹ Perdita Fraser, 1994, op. cit., p. 206.

liberalization of trade, which would lead to the eventual establishment of a joint free trade area. They had suggested using Article 238 of the EEC Treaty as the basis for the new agreement; the Commission was reticent, as this Article refers to the conclusion of Association Agreements.⁶⁰ Nevertheless, in December 1990 the European Council agreed that the Community should go beyond its Trade and Cooperation Agreement to a more comprehensive and important agreement to develop EC-Soviet relations (without mentioning Article 238 or Association Agreements), and should meanwhile offer the USSR substantial food aid and technical assistance.⁶¹ The year that followed, however, was to prove as revolutionary as 1917, and not conducive to the formulation of a new framework for relations between Europe's two greatest powers. By the end of 1991 the USSR no longer existed, thus making a new agreement much more imperative. For the purpose of this thesis, only Russia's post-Soviet relationship with Brussels is examined, but it is worth noting that despite the official statement that 'the Community has no intention of making distinction between "European" and "Asian" republics',⁶² in practice the Western republics are being considered much more seriously as a potential part of an extended European structure than the Central Asian states (the Baltics are in a different category altogether, having either already secured, or been promised association agreements).

At this stage it should be emphasized that at no stage has full Russian membership of the EC/EU been a realistic possibility. Russia's case is arguably the most important one for the EU to solve, as well as the most complex and unpredictable; but Russia remaining a distinct political entity from the EU is one of the few predictions which can be made with certainty in this field. Nevertheless, it is useful not to rely upon an instinctive feeling that Russia could not be an integral part of the EU, and to try to define clearly why this is not a

⁶⁰ Ibid., p. 200.

⁶¹ John Pinder, 1991, *op. cit.*, p. 34.

⁶² 'EC Relations with and Assistance to the CIS', EC Commission background brief, Brussels, 14 April 1992.

possibility, at least in the short- or medium-term. Precisely drawn parameters may become useful one day when sovereign parts of Russia come knocking on Brussels' door.

In theory, an application for EC membership by Russia would have to be taken seriously. The European Council in Maastricht in December 1991 confirmed that 'The Treaty on European Union, which the Heads of State and Government have now agreed, provides that any European State whose system of government is founded on the principle of democracy may apply to become a member of the Union'. Although neither the Maastricht Treaty, nor the Treaty of Rome, define the term 'European State',⁶³ the Council of Europe's Parliamentary Assembly has set a precedent by stating that membership to it 'is in principle open only to states whose national territory lies wholly or partly in Europe, and whose culture is closely linked with the European culture', and declaring that countries whose legislative assemblies enjoy special guest status with the Council of Europe's Parliamentary Assembly, including Russia, are considered European.⁶⁴

Even if it was clear that Russia could be accepted as part of Europe, and that being a full member of the EC was a Russian objective (which, as seen in Chapter One, it is not), the hurdles are insurmountable. If Russia were to join, the area of the EC would be quadrupled, and the population increased by 50%. Also prohibitive would be the expected reaction of the USA and Japan.⁶⁵ Economic and security reasons for this incompatibility are elaborated upon in more detail below, but the main fact is that new members are required to accept the *acquis communautaire*, that is, all the principles and rules which have been adopted so far. This is all the more difficult as the post-Maastricht Europe is a *Union*, moving towards economic and monetary union, a single currency, and the

⁶³ Graham J. L. Avery, 'Europe and the Challenge of Enlargement', report from the EC Commission to the European Council, EC Doc., Lisbon, 24 June 1992, *Biblio post-Maastricht*, no. 7, 1992.

⁶⁴ *Council of Europe Parliamentary Assembly Documents — Working Papers, 1994 Session (First Part)*, 24-28 January 1994 — these were draft recommendations to the Council of Europe's Council of Ministers, later approved.

⁶⁵ Perdita Fraser, 1994, *op. cit.*, p. 220.

introduction of a CFSP; these all dissolve any chance of full membership for Moscow. The administrative implications of such a Union being expanded to include Russia are detailed below.

Only rather recently has the definition of 'association agreements' become more precise and, in the case of 'Europe agreements', clearly exclusive of Russia. For some time in 1992 there was talk of extending an association agreement to Russia, or a hybrid version of it. After all, association agreements have in the past had varying forms. In 1957, France, followed later by Italy and Belgium, demanded special treatment for their former colonies, which led in the end to the Convention of Yaoundé, and the use of association agreements.⁶⁶ Turkey, which has a more tenuous geographical and cultural justification for European status than Russia, and which has had a worse record of treatment of minorities in recent years, has held an association agreement with the EC since 1963. Although the agreement intended to 'create a customs union between the Community and the associated country and to enable the latter to adjust its economy and so to prepare itself for the assumption of duties consequent upon accession',⁶⁷ Turkey's example shows that, despite being provided for in the association agreement, membership is by no means assured.

On the other hand, the pressure which has been applied upon the EC by Turkey to be allowed to graduate from associate to full membership has taught Brussels a lesson; association agreements have since only been granted to countries which are considered very likely to meet EC standards in the foreseeable future. The expectations and fears of other countries which have achieved associate status provide yet more reasons not to grant Russia associate status; East Europeans would be likely to complain that their membership is either being delayed, or diluted, by Brussels concentrating instead on Russian association membership.

⁶⁶ Stephen George, *op. cit.*, p. 26.

⁶⁷ Peter van Ham, 1993, *op. cit.*, p. 195.

Some of the main areas in which East Europeans must improve in order to gain closer association with the EC include: reduction of their budget deficit; development of an efficient dual banking system; development of more sophisticated fiscal systems; development of social policies to replace the abandoned state-provision of many services and goods, and means of financing them.⁶⁸ In all these areas, Russia is a long way behind the Visegrad Four, and the necessary solutions are vastly more complex and time-consuming due to that country's size and longer history of 'Communism'.

Even in the case of the East Europeans, with their relatively simple problems, many officials in the Community question whether the resolve to acquire the *acquis* will not fade, as the social impact of the monetary reforms becomes politically difficult, and as they realize how much of their new found independence they would have to relinquish as part of a single domestic market and foreign policy.⁶⁹ The parliamentary elections in Poland in 1993 substantiated this concern. Whatever reservations of this nature are held by East Europeans can be expected to be felt much more strongly by Russians, considering the fresh memory of Moscow's role as superpower, and its continuing position as major regional power.

Another crucial difficulty in the case of the Visegrad Four, which would become a virtual impossibility in the case of Russia, is the degree of reform that will be needed to incorporate them into the EU's governing mechanisms. Even for the inclusion of the EFTA countries, although the Commission has often optimistically assumed that the EU structure need not be altered, many of the member states have expressed doubt. One well-publicized example of this was during the run-up to the special EC summit of October 1993, when semi-official proposals by France and Germany were disclosed, including the following suggestions: firstly, a voting system in the Council of Ministers which requires

⁶⁸ Heinz Kramer and Fridemann Müller, 'The Economic Requirements for Successful Association' in *The Community and the Emerging European Democracies*, a Joint Policy Report of six national EC foreign policy research institutes, June 1991, pp. 34-36.

⁶⁹ Anna Michalski and Helen Wallace, op. cit., p. 62.

both a majority of member states and a majority of the overall EC population (this would strengthen Germany's position); and secondly, having a European Commission with a maximum of ten Commissioners, to be selected by the Commission President from nominees put forward by the member states, and approved both by the Parliament and the Council of Ministers.⁷⁰ The existing voting system in the Council of Ministers is one where consensus is needed on questions which come under headings considered sensitive, whilst others, such as health and safety, the environment and completion of the single market, go through a process of weighted qualified majority voting (QMV), where twenty-three out of seventy-six votes are needed to block a proposal. Even the extension of this system so that it could cope with a new Union of sixteen, ensuring that around 30% of weighted votes were needed to defeat less sensitive directives, proved to be a major problem.⁷¹

Already, with only Twelve members, the Commission is under-resourced and over-worked. Any increase in the number of member states will require both a rationalization, and greater subsidiarity, and yet still necessitate a substantial increase in the size of the Commission, the Council and Parliament. These changes will prove difficult enough, if the wrangles over changes in QMV are anything to judge by, and yet structural changes will also have to be agreed upon for the EU to stretch into Eastern Europe. Changes are virtually certain to mean that not every country will be assured a Commissioner, and that Presidency of the Council will also cease to be a right of every member, alternating every six months as it does at present. A very recent proposal for restructuring the EU, put forward by a German think-tank, and co-drafted by Chancellor Kohl's personal foreign policy adviser Joachim Bitterlich, suggested that the President of the Council should be elected by the Parliament. This would reflect the increased role of the European Parliament, which according to this blueprint would be equal in power to the Council, creating a two-chamber decision-making process, with

⁷⁰ *The Financial Times*, 29 September 1993.

⁷¹ *The Guardian*, 16 March 1994 and 24 March 1994.

the Council acting as a Senate.⁷² Also requiring major alterations, if the Visegrad Four were to join the EU (to say nothing about FSU states joining), are the CAP and the Budget; the CAP most radically, because agriculture is such a large part of the East European economies, and is relatively backward. Even for the association stage, with increased access to East European agricultural products into the EU, the CAP is proving inadequate. Another hurdle is how to solve the EU's political unaccountability; even if the present rate of 'degressive proportionality' is maintained, with the Eftans and Visegrad Four included in the EU, the number of MEPs would go up to 767, whilst even the new Parliament building in Brussels could only house 750 MEPs. It is interesting to note hypothetically that even at only one MEP per million voters (in these three states), the addition of Belarus', Ukraine and Russia to the EU Parliament would bring the number of MEPs to 977.⁷³

Thus, despite the fact that countries such as Greece, Portugal and Spain are precedents of members admitted largely for political and stability reasons, and that their adaptation period to the *acquis communautaire* was permitted to be gradual and to some extent individualized, Russia's case is too extreme to be seriously considered. The same is also true for the other CIS republics, as confirmed by the then EC Commissioner for external affairs, Hans van den Broek, who declared in early January 1993 that the line on EC membership must be drawn at those who are being tied now to the EC with association agreements.⁷⁴ Even the Parliament, which has consistently taken a more pro-Russian stance than the Council, stated in 1993 that 'it is possible that [...] partnership (with FSU states) could eventually pave the way for an association or something even stronger, although to look ahead in that direction at present would be to engage in political fiction'.⁷⁵ Mostly, however, EU officials have tried to

⁷² *The Guardian*, 21 June 1994.

⁷³ Anna Michalski and Helen Wallace, op. cit., p. 19.

⁷⁴ *The Times*, 29 January 1993.

⁷⁵ *EP Document A3-0201/93*, p. 23.

avoid drawing a clear line between future members and 'no hoppers', wanting to avoid a new separation of Europe and a generation of resentment in the CIS.

Since January 1992, however, it is the Russian Federation which has been knocking, and has been kept waiting in the doorway. For the reasons mentioned above, it soon became clear that the agreement with Russia could not be a full association agreement; and furthermore, whatever agreement was going to be reached with the CIS states was not going to include the intention of full membership in the future. The process of defining this new type of agreement, more than Trade and Cooperation but less than Association, was a slow and arduous one, but is worth analysing as a mechanism to indicate in which spheres Brussels and Moscow easily agree to cooperate, those in which they easily agree not to interact, and those in which the terms of partnership are contentious. To simplify the task of studying the evolution of the Trade and Partnership Agreement, I will first tackle its political aspects, followed by those involving EU-Russian trade, despite the fact that they are, of course, inextricably linked.

The new agreement as a whole has largely been a political exercise. The EU's low level of reliance on types of trade that can be improved by the agreement has already been noted, as has Brussels' desire not to give the impression of favouritism towards East European countries, with whom association agreements had already been signed. The new accord was, to a large extent, intended to soften the blow of the impossibility of EU membership, to avoid any adverse effect on the Russian domestic political scene. The political parts of the proposed accord were the most important, at least as far as the EU was concerned. From the outset, one of the main goals was to increase the foreign policy dialogue between the two sides.⁷⁶ Commission recommendations for these negotiations (with all FSU states), dated July 1992, also suggested that they include provisions for financial assistance, cooperation and aid, and that special attention be paid to support for regional cooperation among the FSU

⁷⁶ Interview with Michael Emerson, *op. cit.*

states.⁷⁷ Contrarily to the Trade and Cooperation Agreement, the new agreement had been intended to officially commit the EC to material assistance to Russia; it was not only to provide for multi-annual funding for TACIS, but also for possible provision of exceptional balance of payments support, complementary to IMF programmes.

On the question of improving intra-CIS cooperation, the Commission suggested to the Council that the EC be ready to use its good offices to help the CIS states reach agreement on trade, payments and regional economic cooperation; Brussels had already managed to do this successfully in the context of ensuring collaboration between TACIS Coordination Units. All the areas of cooperation provided for in the last agreement were to be included in the new one. Jacques Delors was particularly eager to develop the cultural aspect of the accord,⁷⁸ whilst the Head of the EC Delegation in Moscow also pointed out, during the early stages of negotiations, that EC-Russia cooperation in such sectors as transport, education and science, was a specific objective.⁷⁹ Environmental issues were also to figure in the EC proposals, but on this issue the Parliament judged that the suggested measures (by early 1993, at least) were insufficient.⁸⁰

Preliminary consultation with Russia must have started in early 1992, as the first Commission recommendations to the Council on the contents of the new agreements were issued in April.⁸¹ The accord to be signed was officially defined as a Partnership and Cooperation Agreement, and the Commission was instructed to open negotiations for the completion of such agreements with Russia and the other newly independent states by a Council Decision in October 1992.⁸² Round after round of negotiation failed to reach a mutually acceptable compromise, however, despite the fact that the Commission's negotiating mandate was extended in the spring of 1993 (see below).

⁷⁷ *Bulletin of the European Communities-Commission*, no. 7/8, 1992.

⁷⁸ Press Conference given by Jacques Delors in Moscow, 30 May 1992.

⁷⁹ Interview with Michael Emerson, op. cit.

⁸⁰ *Bulletin of the European Communities-Commission*, ECSC-EEC-EAEC, no. 3, 1993.

⁸¹ 'Relations avec les Pays d'Europe Centrale et Orientale et les Etats Indépendants', EC Commission document, for the G7 Meeting, Munich, 1992.

⁸² *Bulletin of the European Communities-Commission*, ECSC-EEC-EAEC, no. 10, 1992.

Disagreements over terms of trade proved to be the more stubborn stumbling blocks, suggesting that the trade aspects of the agreement were both important and as yet insufficient for the Russian side. By the fourth round of negotiations in May-June 1993, however, it became clear that there had been many political hurdles as well. EC officials claimed that talks had stalled largely because of Russian objections to EC demands for guarantees on human rights, rejecting the 'suspensive clause' according to which the EC could suspend implementation of the agreement should there be severe human rights breaches.⁸³ Some of the other bones of contention were exposed by Russia's chief negotiator, Deputy Premier Aleksandr Shokhin, on his return from talks with the EC Commission's Vice-Chairman for Foreign Trade, Sir Leon Brittan. He stated that Russia could at last expect a lowering of EC demands in the following spheres: the movement to free price structuring in Russia; the need to develop economic relations with other newly independent states; and the restrictions on Russian workers in the EC.⁸⁴ The first two of these points should be considered political, as they are more an attempt to influence the political situation in the CIS than to affect trade with the EC.

This period of late May and early June 1993 saw an intensification in negotiations, first between Shokhin and an EC delegation including Poul Rasmussen, Head of the Danish government and then President of the Council of Ministers, and later between Prime Minister Chernomyrdin and Sir Leon Brittan.⁸⁵ This produced some results, as by the end of June Russia's Ambassador to the EC, Ivan Silaev, said that accord had been reached upon the political chapters of the Partnership Agreement, concerning 'coordination of actions on key problems of international life'; only the commercial and economic parts remained problematic.⁸⁶ One of the major political breakthroughs of this negotiating period was the elevation of Russia to the same formal level of

⁸³ *International Herald Tribune*, 5 June 1993.

⁸⁴ *Kommersant*''', 1 June 1993.

⁸⁵ Maiak radio, 7 June 1993.

⁸⁶ *St Petersburg Press*, no. 7, 22-28 June 1993

political relations with the EC as enjoyed by the USA and Canada, involving twice-yearly summits between Brussels and Moscow; this had supposedly been proposed by Prime Minister Major.⁸⁷ Nonetheless, and despite a further commitment from the Copenhagen Council to intensify the negotiation process, disagreements on trade had still prevented the Partnership and Cooperation Agreement from being sealed at the Brussels Summit in December 1993.

It is very significant that the EC attempted to use any progress achieved in negotiations to boost President El'tsin's image, and conversely to underplay the significance of the continued inability to reach consensus. In other words, Brussels was much more interested in maintaining good relations with Russia, and not weakening the positions of the pro-reformers, than with speeding up or optimizing the conclusion of the Partnership Agreement. Even when the Minister for Foreign Economic Relations, Sergei Glazev, declared that the EC's continued trade discrimination was tantamount to a trade war, and that Russia was ready to reciprocate,⁸⁸ Brussels merely calmly replied that in part Russia's economy had to be out of transition to be treated as other free-market economies, and partly that even free-market economies are subject to specific quotas (see below). Brussels also failed to react to El'tsin's snub of the invitation to Copenhagen just before the Council, to at least sign a declaration of intent on the agreement. On the other hand, the EU publicized the first summit between EC Commission President Jacques Delors, the Belgian Council President, and President El'tsin.⁸⁹ Brussels avoided criticizing El'tsin on the undemocratic measures he had advocated during the run-up to the December 1993 elections, and again invited him to a pre-Council meeting to sign a declaration of intent on the Partnership Agreement, this time conveniently just before the Russian elections.⁹⁰ Brussels has played a balancing game of trying to have some influence on El'tsin through the new agreement, yet also using it to grant influence to El'tsin *vis-à-vis* his

⁸⁷ *The Moscow Times*, 22 June 1993, and *The Guardian*, 23 June 1993.

⁸⁸ *Kommersant'*, 27 May 1993.

⁸⁹ *The Financial Times*, 10 November 1993.

⁹⁰ *The Guardian*, 12 November 1993.

domestic opponents. The positive relations established with El'tsin's government were seen as too important, and too fragile, to put at risk over details of the Partnership Agreement.

I shall now turn to the trade and commercial aspects of the evolving agreement. The above description of the Trade and Cooperation Agreement showed that many avenues were left open to block imports from the ex-USSR: specific restrictions until 1995; the safeguard clause; and a continued disregard for prices set in the CIS, as they were still considered state-trading, therefore requiring minimum prices to be set with reference to production costs in free-market states. There was pressure from many sources in the EU to reduce the protectionism towards Russia, largely because all other efforts of assistance could be of only limited value without the possibility of translating new knowledge or technology into export earnings. The European Parliament defended this position, just before yet another round of negotiations between the Commission and the Kremlin in late May 1993, adopting a statement calling for wider access to exports from the FSU.⁹¹ The Parliament's Resolution particularly mentioned controls over textiles, coal and steel and nuclear products, and asked the Commission to carry out studies on the effect of liberalizing trade with Russia in these goods.⁹² It has been suggested that the Community has little to fear in opening its own market even in some of the so-called sensitive sectors, where Russia has a potential comparative advantage, as the present economic chaos in Russia means that large-scale increases in exports are unlikely to be common.⁹³

Trade relations between the two sides had already received a notable boost at the end of 1992 when the EC decided to extend the General System of Tariff Preferences (GSP) to Russia and the other CIS states.⁹⁴ The GSP scheme

⁹¹ *Bulletin of the European Communities-Commission*, ECSC-EEC-EAEC, no. 5, 1993.

⁹² *EP Doc. A3-0073/93*, Motion for a Resolution, passed by the Committee for External Economic Relations, 24 February 1993.

⁹³ Perdita Fraser, 1994, op. cit., p. 220.

⁹⁴ 'Delegation of the Commission of the European Communities in Moscow — Press Release', 25 March 1993.

developed from the second United Nations Conference on Trade and Development (UNCTAD) in 1968; it is normally directed at less developed countries. This provided ammunition for groups who would lose out from GSP being applied to Russia to try to reverse her inclusion, but the European Parliament rejected this proposal.⁹⁵ The current EU scheme allows duty-free access for all industrial products apart from a defined list of sensitive goods, and preferential entry to a limited range of (mainly processed) agricultural products. This is as opposed to the usual Most Favoured Nation (MFN — a misnomer, therefore, as GSP is preferable) tariff for most industrialized goods, of around 5-7%. Under GSP, for each sensitive industrial product, each beneficiary country not subject to a fixed duty-free amount (FDFA) is granted an individual tariff ceiling. After a FDFA is reached, full duty is automatically reinstated, whilst for tariff ceilings, full duty will only be reimposed if a member state succeeds in showing damage to its industry, the duty then being reimposed for the whole of the EU. In certain circumstances preferences are reduced or excluded for certain countries; for Russia, this is only the case for urea. Products which are considered non-sensitive may be included on the sensitive list if a member state can show that the GSP for that product is damaging to its producers. A separate regulation applies for textiles — the Multi-Fibre Arrangement (MFA). For agriculture, only a few products are included in the GSP, for reduced rates of duty. There are separate rulings on some iron and steel products, under the ECSC, but they do not benefit the CIS.⁹⁶ The GSP was to apply to Russia from 1 January 1993, but in practice enactment was delayed, as the Russian government had to satisfy the EC that it had a trustworthy system of certification of origin. Finally, in late May 1993, the Ministry of Foreign Economic Ties and its plenipotentiary offices could issue 'certificate of origin type A' documents, which would be satisfactory proof to obtain exemption from EC tariffs. The process involves obtaining the form, producing a copy in English or French, obtaining an

⁹⁵ *Europe*, 21 January 1993.

⁹⁶ *Generalised System of Preferences — A Brief Summary of the European Community's Scheme for 1993*, London, Department of Trade and Industry, 1993.

'expert' certificate of origin from the regional chamber of commerce and industry (minimum cost of this was Rb30,000, or \$30, in May 1993), as well as paying Rb8,000 per certificate to the Ministry of Foreign Economic Ties.⁹⁷ It should be stressed that only a minority of Russian exporters had to face this bureaucratic procedure to be exempted from duty, however, as there are relatively few industrial goods which are exported to the EU from Russia, once textiles, coal and steel are excluded. Even in the case of Central and East European countries' exports, it has been estimated that the combined impact of non-eligible goods and strict rules of origin reduces GSP benefits to one-third of industrial and manufactured exports;⁹⁸ in Russia's case, an even lower percentage of exports are likely to be favoured by GSP. In other words, the Partnership and Cooperation Agreement still had much to achieve if it was to significantly help Russian exporters.

On specific restrictions, Aleksandr Shokhin listed several goods on which agreement had still evaded the negotiators in the fourth round, namely steel, aluminium, coal, uranium, textiles and space technology.⁹⁹ On all of these exports, Russia was requesting tariff concessions.¹⁰⁰ The Russian Deputy Prime Minister also expressed dissatisfaction at the proposed treatment of Russian companies in the EC, although it was unclear why the Russian delegation was unhappy with the official position of the Community, which called for EC companies operating in Russia to have the choice between MFN treatment or that of national companies, and Russian companies in the EC to benefit from the treatment accorded to national companies in the country of establishment.¹⁰¹

From the beginning, Russia has been the side pushing for a more far-reaching agreement, in particular looking for a guarantee of the 'four freedoms'

⁹⁷ *Kommersant*'', 25 May 1993.

⁹⁸ P. Aghion; R. Burgess; J.-P. Fitoussi and P. A. Messerlin, 'Towards the Establishment of a Continental European Customs Union' in *Trade, Payments and Adjustments*, eds J. Flemming and J. M. C. Rollo, RIIA, London, 1992, p. 170.

⁹⁹ *Kommersant*'', 29 May 1993.

¹⁰⁰ *Europe*, 4 June 1993.

¹⁰¹ *Europe*, 1 April 1993.

of goods, services, capital and persons.¹⁰² Germany in particular pushed for definite promises of Russian participation in a common free trade area, subject to certain conditions, whilst others would have preferred to avoid making committing references to the four freedoms.¹⁰³ Promising a free trade agreement was expected to create particular difficulties in the services industry, especially over transportation and commercial satellite launches.¹⁰⁴

In the end, such was the desire to accommodate Russia, and so determined was Germany in particular to do this, that the very nature of the agreement was altered to encompass a capacity to switch to a truly free market between Russia and the EU; the Commission's negotiating mandate was extended by the EC General Council of foreign ministers in April 1993.¹⁰⁵ It was also this Council which established that the condition to the enforcement of this free trade arrangement was Russia's ability to comply with GATT obligations.¹⁰⁶ The use of GATT as a benchmark is a natural gesture; already, the EC's anti-dumping rules had been based largely on Article VI of the GATT (as well as the 1979 Anti-Dumping Code).¹⁰⁷ Moscow's involvement with GATT was by no means new. The USSR first officially applied in August 1986 to acquire observer status to GATT, but this was refused; however, after securing the support of President Bush in Malta in December 1989, and then of the European Council in Strasbourg in the same month, the Soviet Union was finally admitted with observer status on 16 May 1990.¹⁰⁸ Brussels' insistence on compatibility with GATT before proceeding with the free trade status has greatly intensified the efforts towards gaining full GATT membership. On 6 June 1993, El'tsin stressed Russia's wish to become full a member of GATT, and hoped that the issue could

¹⁰² *Europe*, 4 June 1993.

¹⁰³ Perdita Fraser, 1994, *op. cit.*, pp. 208-09.

¹⁰⁴ *Kommersant*''', 1 June 1993.

¹⁰⁵ *Europe*, 5 April 1993.

¹⁰⁶ *Bulletin of the European Communities-Commission*, no. 4, 1993.

¹⁰⁷ *European Economy*, no. 52, 1993, p. 196.

¹⁰⁸ Leonard Geron, *op. cit.*, p. 56.

be examined at GATT's meeting ten days later.¹⁰⁹ By the end of 1994, though, full GATT membership still eluded Moscow.

Although stating that full GATT membership was desirable, the Russian negotiators were not going to allow it to be a *sine qua non* of a free trade accord. This stance could be justified by the fact that Brussels' 'evolutionary clause' was not insistent on membership of GATT itself, but on the ability to meet GATT obligations.¹¹⁰ Deciding when to judge if these obligations could be met became an important impasse. At first the EC wanted to leave the question open-ended, and later showed willingness to review Russia's status after six years, while Moscow wanted this to occur after two years. At the November 1993 EU-Russia summit, Delors announced that 1998 was being offered as the earliest date when a common free trade zone could be created.¹¹¹ The EU came to this first summit with another gesture of good will — it altered the Commission's mandate to allow for slightly better access for Russian steel and aluminium. More importantly, it changed Russia's status from 'state trader' to 'economy in transition', the main advantage of this being that now the Commission would have to prove 'substantial damage' to EU producers if anti-dumping measures are to be taken; furthermore, the use of 'safeguard clauses' became justified only if the EU could show that Russian goods were both underpriced *and* that there had been a significant surge in imports.¹¹² This was an important concession indeed, which addressed the heart of the problem preventing agreement.

Yet despite these measures, and having secured the right of foreign creditors to seize Russian property abroad in the case of non-repayment, by the December 1993 Council El'tsin could still only sign an intention of agreement. Many areas of trade had not yet been resolved to each side's satisfaction. Sir Leon Brittan had suggested that trade in these difficult areas be dealt with in separate accords, or in a 'revision clause', in order to conclude the main

¹⁰⁹ *Kommersant*''', 27 May 1993.

¹¹⁰ *International Herald Tribune*, 5 June 1993.

¹¹¹ *The Financial Times*, 10 November 1993.

¹¹² *The Financial Times*, 10 November 1993.

Agreement, but the Russian side rejected this, apart from the special case of 'nuclear cycle' goods.¹¹³ Nonetheless, there was reason to be optimistic; after the November summit, Alexandr Shokhin declared that no important hurdles remained. Finally, the Partnership and Cooperation Agreement was signed at the Corfu Summit in late June 1994, the latest delay having been blamed in part on continuing problems with the treatment of EU banks in Russia,¹¹⁴ although reports from early spring suggested that agreement had already been reached, and that signature simply awaited a suitably grand occasion. It is also likely that Moscow may have wanted to wait for agreement to be reached on the Partnership for Peace with NATO before signing the Partnership Agreement, trying to make the latter dependent upon the former. Whatever the case may be, Russia now joins Ukraine in having provisional Partnership status with the European Union. This status was provisional, however, pending ratification by the parliaments of Russia and the EU member states; this ratification had not occurred by the end of 1994, and was going to be delayed further by the war in Chechnia.

The Partnership Agreement was concluded for an initial period of ten years, after which it would be renewable. In the mean time, the Agreement is to be renewed automatically yearly, unless written denunciation of the Agreement is presented by one party (either the EU or Russia) to the other. Importantly, the Agreement includes a clause covering human rights which allows it to be suspended, even unilaterally, in an emergency.¹¹⁵ The Agreement does not, however, prevent a party from taking any measures which it considers necessary for the protection of its essential security interests, whether in relation to sensitive information, fissionable materials, production of or trade in war materials, or in the event of serious internal disturbances or international tension. Neither does the Agreement prevent a party from taking measures which it considers necessary

¹¹³ *Moskovskiy novosti*, no. 24, 13 June 1993, and *Europe*, 4 June 1993.

¹¹⁴ *The Guardian*, 15 June 1994.

¹¹⁵ *Proposal for a Council and Commission Decision on the conclusion of the Agreement on Partnership and Cooperation between the European Communities and their Member States on the one part, and Russia on the other part*, Brussels, Commission of the European Communities, COM(94) 257 final, 15 June 1994, pp. 1a and 2.

in line with generally accepted international obligations and commitments in the control of dual-use industrial goods and technology.¹¹⁶ There were therefore no benefits to be expected from the Western side in terms of limiting Russia's arms sales, nor from the Russian side relating to post-CoCom technology trade restrictions.

In common with the Trade and Cooperation Agreement, the Partnership Agreement established a Cooperation Council to monitor the implementation of the Agreement. This Council is to meet once a year at ministerial level, and when circumstances require. The Council consists of members of the European Council, the European Commission, and members of the Government of the Russian Federation; the office of President of the Council is held alternately by a representative of the EU and by a member of the Russian Government. The Cooperation Council is assisted in the performance of its duties by a Cooperation Committee composed of representatives of the same three authorities represented in the Cooperation Council, normally at senior civil servant level; the Committee is to be presided over alternately by a representative of the EU and of the Russian Government. The Committee's main role is to ensure continuity between meetings of the Cooperation Council. New to this Agreement is the establishment of the Parliamentary Cooperation Committee, consisting of members of the European Parliament and of the Federal Assembly of the Russian Federation. The Parliamentary Cooperation Committee, which was to establish its own rules of procedure, does not have a clearly defined role; all that is specified is that it can request information regarding the implementation of the Agreement from the Cooperation Council, and that it can make recommendations to this Council.¹¹⁷

One of the most important elements enshrined by the Partnership Agreement is that of political dialogue, especially the meetings which shall take place 'in principle' twice a year between the Presidents of the European Council,

¹¹⁶ *Ibid.*, Article 99, pp. 56-57.

¹¹⁷ *Ibid.*, Articles 90-97, pp. 53-54.

the European Commission, and of the Russian Federation. The Agreement also pledges to set up procedures and mechanisms for biannual meetings at senior official level between the European Union Troika and Russian officials, as well as the dialogue through the Council and Committees described above.¹¹⁸

The Partnership and Cooperation Agreement, as its title suggests, also stresses that cooperation between the parties will be increased in many areas. The cultural aspect of interaction which had been stressed by Delors was covered by an Article which promised cooperation particularly in exchanges of information in the field of conservation of heritage, and between institutions of culture. As expected, education and science are also included. In education, cooperation is aimed not only at higher education, but also civil servants, journalists, interpreters, adult training, and others. In science and technology, collaboration is specified in the exchange of information, training activities and mobility programmes for scientists and technicians, as well as R&D activities. A particularly detailed section covered cooperation on environment and human health, calling especially for disaster planning, an exchange of information and experts, bringing laws to Community standards, cooperation through the European Environment Agency, development of strategies with regard to global issues and achieving sustainable development, and environmental impact studies. There are numerous other areas in which both sides commit themselves to cooperation.¹¹⁹

Technical assistance, as a means of achieving the cooperation mentioned in the Agreement, is only pledged in a few instances. In the field of social cooperation, it is stated that cooperation shall include technical assistance (TA) to

¹¹⁸ Ibid., Articles 6-9, p. 6.

¹¹⁹ Ibid., Articles 56-85, pp. 34-51; the other fields are: industrial restructuring and interaction; investment promotion and protection; standards of conformity assessment and consumer protection; mining and raw materials; agriculture and the agro-industrial sector; energy; the nuclear sector; civil space research and commercial application; construction; transport; postal services and telecommunications; financial services; regional development; health and safety of workers, optimization of the labour market, and social protection; tourism; small and medium enterprises (SMEs); communication, informatics and information infrastructure; customs systems (cooperation in this sphere was also covered in a detail protocol); statistical cooperation; economic policy; and the prevention of illegal activities including illegal emigration, traffic of narcotics, and corruption.

optimize labour markets, plan and manage restructuring programmes, and promotion of self-employment and entrepreneurship; TA was also to be provided to develop social assistance institutions. In the promotion of SMEs, there was particular mention of access to and operation of the Business Cooperation Network, and of Euro-Info-Correspondence Centres, which are part of TACIS. The regulation of capital movements and payments in Russia was to be aided with TA to exchange information, establish links between competent authorities on both sides, and develop appropriate regulations in Russia. Finally, in the prevention of illegal activities, TA was to include the drafting of national legislation, the creation of information centres, the training of personnel, and the development of joint strategies.¹²⁰ This is the closest the Agreement comes to including precise provisions for aid and financial assistance. No specific monetary amounts or period of duration are mentioned in relation to TACIS, or to financial assistance, contrarily to what had been speculated upon during the time of negotiations. Financial assistance is mentioned solely in the form of grants for TA, which are still to be covered by the TACIS framework.¹²¹ The only other benefit stipulated is in a joint declaration exempting financial loans and credits granted for assistance purposes from MFN conditions.¹²²

In terms of reducing EU protectionism towards Russia, the Agreement's achievements are limited. There is recognition that Russia is no longer a state trading country but an 'economy in transition', with the implications discussed above. Thus, imports may still be restricted, although normally after consultations through the Cooperation Committee, in cases where a product is being imported in such increased quantities as to cause substantial harm to domestic producers.¹²³ Although quantitative restrictions on the whole were abandoned, the Agreement still does not cover nuclear products, coal and steels, and textiles. Concerning nuclear products, both sides agreed to 'take all

¹²⁰ Ibid., Articles 74, 76, 83 and 84, pp. 44, 45, 49 and 50 respectively.

¹²¹ Ibid., Articles 86-88, p. 52.

¹²² Ibid., 'Joint declaration in relation to article 10', p. 83.

¹²³ Ibid., Articles 13-17, pp. 8-9.

necessary steps' to arrive at an arrangement by 1 January 1997. For issues concerning trade in coal and steel, a joint Contact Group was to be established.¹²⁴ Despite Russian requests during preparations for the Agreement, no special conditions were granted for trade in aluminium, uranium or space technology, leaving these still open to anti-dumping measures. In Russia's case, QRs could also be applied to EU imports when needed to protect sectors 'undergoing restructuring', 'newly emerging', or 'facing serious difficulties', until such a time as Russia becomes a member of GATT.¹²⁵

Concerning conditions for Russian workers in the EU, workers 'legally employed' in a member state were promised access to the applicable pensions in respect of old age, death or industrial accident, 'with the exception of special non-contributory benefits'.¹²⁶ The Agreement did not, however, stipulate any measures to facilitate the employment of Russians in the EU. With regards to the establishment of companies from one party on the territory of the other, both sides agreed to grant treatment no less favourable than that offered to domestic companies. In the EU's case, exceptions to this were in fishing, real estate purchase, audiovisual service, telecommunications, agriculture, and news agency services. In Russia's case, this article did not apply to air and maritime transport, and there were also exceptions in banking and insurance services.¹²⁷ The situation concerning banks, which caused so much delay to the Agreement, is particularly convoluted. In relation to Russian subsidiaries of EU banks, Russia reserved the right to continue to apply the ceiling to the overall share of foreign capital in the Russian banking system which was in operation on the date of the Agreement, and to retain the higher minimum capital requirement in force on the date of the Agreement. For a period of five years, in relation to banks established after the date of the Agreement, Russia could also restrict the number of Russian branches, set a minimum level for balances on accounts of 55,000ECU, and

¹²⁴ Ibid., Article 22, p. 11, and Article 21, p. 10.

¹²⁵ Ibid., Article 15, p. 8, Annex 2, p. 61, and Annex 9, p. 72.

¹²⁶ Ibid., Article 24, p. 12.

¹²⁷ Ibid., Article 28, p. 14, Annex 3, p. 62, and Annex 4, p. 63.

prohibit transactions in shares of Russian companies; finally, until 1 January 1996, Russia could also prevent EU banks established after 15 November 1993 from carrying out transactions with Russian residents.¹²⁸

Further privileges were accorded to Russia in terms of aid to exporting industries. In general, such support could be granted to primary products for a period of three years, or to struggling or emerging industries for a period of five years.¹²⁹ The Russian authorities were also permitted to continue to apply restrictions on outwards direct investment by Russians, as well as capital movements which affect the currency exchange rate.¹³⁰ Other significant aspects of the Agreement include the guarantee from both sides that internal restrictions for goods from the other party will be no greater than for domestic goods, and both parties grant the right of transit through their territory of goods originating in or destined for the other party.

Although in terms of trade advantages for Russia the Partnership Agreement is less pivotal than may have been expected, it nonetheless constitutes a crucial step forwards in relations between Russia and the European Union, establishing a workable framework for foreign policy coordination, and opening the possibility for very close economic interaction in the future. The economic aspects of the Agreement are certainly not without value, otherwise they would not have caused such protracted political wrangling; the decreased likelihood of anti-dumping procedures being applied to Russian exports is of particular importance. What remains to be seen is to what extent the spirit of the Agreement will be adhered to, in terms of minimizing barriers to Russian trade with the EU, and with regards to the establishment of the eventual free trade area.

¹²⁸ Ibid., Article 29, p. 15, and Annex 7, pp. 68-69.

¹²⁹ Ibid., Article 53, p. 31.

¹³⁰ Ibid., Article 52, pp. 29-30.

2.6 On the Road to a Pan-European Economic Structure?

Potentially the most important aspect of the Partnership Agreement is that it clearly establishes the prospect of a future free trade area. It is stated that one of the objectives of the Agreement is:

to create the necessary conditions for the future establishment of a free trade area between the Community and Russia covering substantially all trade in goods between them, as well as conditions for bringing about freedom of establishment of companies, of cross-border trade in services and of capital movements.

The parties undertake to develop the relevant Articles, 'as circumstances allow', with a view of establishing this free trade area. 'The parties shall examine together in the year 1998 whether circumstances allow the beginning of negotiations on the establishment of a free trade area'.¹³¹ Despite the pressure from Germany, the conditions necessary for Russia's admission were not clarified in the Agreement; neither were the precise aspects of trade which were to be further liberalized. The proposed free trade agreement is in fact likely to be a variation on the present European Economic Area (formerly known as the European Economic Space, but renamed as there were fears of connotations with 'void' or 'nothingness') between the EU and EFTA, although aiming at a lesser level of compatibility. There are no references in the Partnership Agreement to the existing EEA, but it is most likely to be the basis for the eventual EU-Russia free trade area. The superimposition of a new free trade area on top of the EEA would represent a tremendous amount of duplication, confusion, and irritation. Providing that it is accepted by all sides that Russian participation in no way signifies a first step towards EU membership, the economic aspects of such an extension of the EEA need not be particularly threatening.

In terms of freedom of goods from Russia, the abolition of duties and tariffs could be expected, as could a higher degree of compatibility of standards

¹³¹ Ibid., Articles 1 and 3, pp. 4-5.

and definitions of goods. Greatly reduced use on the EU's part of clauses which allow anti-dumping measures, however, appears unrealistic. In cross-border trade in services, the restriction to those spheres listed in Annex 5 could reasonably be expected to be dropped by Russia, as could the interdiction on such services being paid for in that country, as is the case under the Partnership Agreement. The freeing of capital to a much greater extent than in the Agreement is likely to be more problematic. As mentioned in Article 52, areas which need much more liberalization include movements in portfolio investment, commercial credits and financial loans. Financial services need to develop to a much greater extent in Russia, as does trust in the Russian authorities, for capital movements to be truly free. Freedom of persons could be relatively easy to achieve in terms of mutual abandonment of the need for visas; the precedents set with countries such as Poland give an indication of the feasibility of this. On the other hand, any hopes of Russians having the freedom to seek work in the EU would be unrealistic.

This scheme is the clearest sign yet that the EU is willing to be the core of a pan-European structure of some kind, whilst still insisting that this framework be organizationally independent of the Union itself. In this, these proposals are in keeping with many of the traditional plans for a new Europe. Jacques Delors' vision, at the end of the 1980s, of a Europe of concentric circles,¹³² may now be closer to realization; an inner circle of the most committed EU members, with a common currency and military capacity; an outer circle of EU members, stalling on monetary union and military union, but in every other way integrated; a circle of associated members, consisting of East European and Baltic states, as well as perhaps some EFTA countries who continued to resist the losses of sovereignty involved in joining the Union; and finally, some or all of the CIS states, included in a free trade area of abolished tariffs and compatible fiscal and legal systems, but without tight links in currency or interest rates, nor any view to full Union membership. Including Russia in a European Economic Area (EEA) moves somewhat away, though, from Valéry Giscard d'Estaing's vision a few years later

¹³² *The Economist*, 25 November 1989.

of a 'European Village', consisting of several European Homes: (i) the Twelve; (ii) the EFTA countries; (iii) the East European countries of the Warsaw Pact; (iv) 'isolated' countries — Yugoslavia, Albania, Malta; (v) the European part of the Soviet Union.¹³³ The assumption in this perspective was that interdependence was to be much greater within the Houses than between them, but in fact cooperation within the FSU, for example, has proven to be very elusive on account of mistrust, anxiety about continued dependence on Russia, and a need for Western rather than Soviet technology. Even between East Europeans, agreements have been aimed more at successful membership application to the EU than at increasing trade amongst themselves.

The existing concept of an EEA began to be taken more seriously in the 1980s, to allay Eftans' fears of being left in the cold by EC integration, yet not leaving application for membership as their only option. Whilst the European Free Trade Agreements in the early 1970s were essentially concerned with the elimination of customs duties on industrial products, the EEA Agreement established the 'four freedoms'. The EEA also aims to increase cooperation in fields relating to economic activity which directly affect the four freedoms — the so-called 'horizontal' policies, including social policy, consumer protection, the environment, statistics and company law. Joint action is also expected in areas outside the four freedoms, in the form of EFTA participation in Community programmes, projects and actions concerning research and development, the environment, social policy, information services, education, training and youth, SMEs, tourism, and other areas.¹³⁴ The fact that the integration process in the EEA has allowed many of its members to be accepted for full EU membership shows a high degree of success in making economies compatible with the EU, but, on the other hand, also shows that the EEA is not considered an adequate substitute to the Union. During this process of integration, EFTA countries have met with numerous and serious problems, which are likely to be even more

¹³³ Valéry Giscard d'Estaing, *op. cit.*, p. 656.

¹³⁴ *Background Report — European Economic Area — Background Briefing*, EC Commission, London Information Office, 13 January 1994, p. 2.

damaging in Russia's case. In other words, whilst an eventual free trade area with Russia may be based on the EEA, even attached to it, Russia cannot realistically be expected to have all the benefits of the countries already in the EEA today.

Although the Economic Area is supposed to deal purely with economic aspects of relations between the EFTA and EU states, one of the most basic hindrances is the artificiality of the distinction between economic and political integration; the interdependence of these two spheres has meant that it has been very difficult for all sides to agree on where to draw the line on the integration process. On one hand, the high level of necessary compatibility of systems and scale of economic interpenetration has been problematic for some members, yet on the other hand the lack of a customs union has created friction, undermining much of what the EEA has to offer. The asymmetry between EU and EFTA members proved to be an obstacle to mutual accommodation, with partial participation of Eftans in the decision-making process, for example, proving to be frustrating for them, and cumbersome for the EU.¹³⁵ Many specific examples of these impediments were exposed in 1993, as frustration grew with the inability to finalize the terms of the EEA. Iceland, for example, remained very reluctant to join, mainly due to its fishing resources which it does not want to share; Switzerland, followed by Liechtenstein, could not accept the loss of sovereignty involved when they continue to be refused an opt-out clause from individual EEA laws (as opposed to an opt-out for EFTA as a whole, which is catered for). To enforce EEA laws, a joint panel of five judges from the European Court of Justice and three from EFTA countries (from a pool of seven, one for each member) was established. Yet, so far, the Twelve have refused to put this EEA legal body on equal footing with the European Court of Justice, thus generating more antagonism.¹³⁶

¹³⁵ J. M. C. Rollo and Helen Wallace, *op. cit.*, p. 57.

¹³⁶ *The Financial Times*, 15 May 1993.

Despite the setbacks, however, the EEA has managed to greatly further the cause of wider European integration, and at the same time managed to delay applications from EFTA states long enough to get the Twelve firmly on the road to an integrated Union. The EFTA countries, through the EEA, had already adopted over 60% of the EC's *acquis* (meaning 60% of the legislation and commitments to standards relating specifically to the EC) by 1992.¹³⁷ It is now expected that the EEA will play the same delaying yet integrating role with the Visegrad Four, to be thought of as a 'comfortable ante-chamber'. It had been thought that the East Europeans might be introduced to the EEA sooner rather than later, in part to lower the expectations of the Eftans in the conditions of acceptance into the EU, especially in the fields of social and environmental protection, as these could not be met by the Eastern members of the EEA. This has failed to happen in time to affect the conditions of membership of the EFTA countries which were to join the EU in 1995, but the same principle may be used with Russia — in order to delay demands of high levels of integration from East Europeans, the inability of Russia to join the EEA under those conditions may provide a welcome excuse for Brussels to slow down the Visegrad Group's drive for compatibility with the EU.

In any case, the prospect of Russia's inclusion in the EEA is now more feasible, as long as reforms advance far enough to allow qualification for full GATT membership. Not only would it be an effective mechanism for further guidance of Russian economic reforms, but it may also be politically soothing. The problem is that the EU member states are not ready to pay the price, in terms of trade competition, needed to grant Russia more than a policy of rejection. The protectionism which member states have so far imposed on the Commission seems likely to continue, so that even if a pan-European free trade area is made accessible to Russia, it is unlikely, at least in the near future, to greatly open up those areas of trade which have not already been freed. That is not to say that the symbolism of such a continent-wide free trade area would not be of value, nor

¹³⁷ Anna Michalski and Helen Wallace, 1992, op. cit., pp. 57 and 30.

that limited improvements in the Russian access to the EU markets would not be better than none at all — any such agreement would be of positive value. It is likely to take the form, however, of a first step, rather than the full achievement of free trade throughout Europe from the first day of such an agreement.

2.7 The Security Dimension of the New Europe — As Seen From the European Union

Arguably the most sensitive aspect of the new relations between Russia and Western Europe is that of security. As has now been made clear more than once in this thesis, Russia is not realistically considered as a potential member of the European Union, and a major reason for this is its geostrategic and military might. The EU's CFSP will be considered much too closely-knit an alliance to be shared with Russia, as long as she is both as powerful and as unpredictable as she is now; only a long period of successful partnership in a less binding association could reverse this Western perspective. Many structures for a new security arrangement throughout Europe have been brandished by politicians and academics, as we shall see below, but none of them foresee the precise future role of Russia. The prospect of trying to tie the Russian 'bear' to Western Europe, however loosely, is a fearful one for many. Nevertheless, this question has to be addressed, for without its solution all other pan-European structure, including any Agreement between the EU and Russia, will only solve part of the equation, and will be vulnerable to changes depending on the security situation.

'Whatever else it might turn out to mean, Gorbachev's "Common European Home" would be a home dominated by the Soviet Union', stated one commentator in 1990.¹³⁸ At around the same time Giscard d'Estaing believed that the USSR could not be included in the political sphere of a new Europe

¹³⁸ Ian Davidson, 'The Search for a New Order in Europe', *International Affairs*, London, vol. 66, no. 2, 1990, p. 282.

because it would not be ready to give up conducting global diplomacy on other continents.¹³⁹ The sheer size of the country has also been intimidating to European decision-makers; for example, a former vice-president of the Commission stated that 'Russia is a special case, if only because of its size, which could threaten the interior equilibrium of the Community. [...] It would be as if the USA were part of the Community'.¹⁴⁰

The growing unrest in Russia, caused by the ever-increasing poverty and inequality, compounded the West's insecurities about attempting a close security alliance with Moscow. The severe economic slump has created a real possibility of widespread civil war in a nuclear country, either through spontaneous unrest, or instigated by a populist regime which may come to power. The success of Vladimir Zhirinovskii's Liberal Democrats in the December 1993 elections demonstrated the feasibility of the latter phenomenon. Even before the election, there were many signs that Russia was shifting back to a policy of optimizing geostrategic gains, at the expense of relations with Western countries, as shown in Chapter One. This new self-determination in security policy included a reversal of the policy of 'no first use' of nuclear weapons, which was supported first by Brezhnev and later by Gorbachev. The abandonment of the nuclear-free doctrine of the late 1980s was not entirely surprising or unpredicted. Willem van Eekelen, General Secretary of the WEU, wrote in 1990 that the Kremlin was likely to accept that the inherent danger in conventional warfare is that it is calculable, and that particularly after the disappearance of the buffer zone, this made a nuclear deterrent very desirable;¹⁴¹ Moscow's readiness to resort to first use of nuclear weapons may be simply an extension of the same argument. Combined with Moscow's new determination to keep its military sphere of influence, however, the new doctrine has been worrying for Western analysts. Russia's ruthless readiness to put down Chechnia's pro-independence

¹³⁹ Valéry Giscard d'Estaing, *op. cit.*, p. 656.

¹⁴⁰ *Revue du marché unique européen*, February 1992, article by Martin Bangemann, former Vice-President of the Commission.

¹⁴¹ François Heisbourg (ed.), *The Strategic Implications of Change in the Soviet Union*, Houndmills, Macmillan, 1990, p. 48.

government, which erupted at the very end of 1994, has obviously been of even more concern.

All these developments have undeniably complicated the prospects for the building of a new security structure in Europe, but they do not change the fact that Europe is still much safer from superpower conflicts than it was ten years ago. The following factors have all greatly increased security in Europe: the elimination of medium-range missiles, including those of shorter-range (500-1,000 km) and American warheads in Germany, under the INF Treaty; asymmetrical reduction of conventional forces (especially significant, as this greatly reduces the risk of surprise attacks); the signing of the START I and II Treaties, to be complemented with unilateral measures; NATO declaring that the USA and Britain will reduce their tactical nuclear weapons in Europe by 80%.¹⁴² Perhaps most importantly, the withdrawal of Russian troops has been completed in all the former satellite states of Eastern Europe. Also of significance is that Russian nuclear missiles are no longer aimed at Western targets. Every one of these reductions in the threat of Russian aggression make the possibility of joint security structures more realistic, Moscow's geostrategic position now offering less threat and leverage.

The road to a pan-European security arrangement was made less improbable by the declining military role of the United States in Europe. In an American directive on military planning for 1994-99, Washington stated for the first time that it was not against the creation of a purely European security structure.¹⁴³ After the elimination of American land-based nuclear missiles in Europe, and the decrease in American troops due to financial pressures on Washington's budget, a new level of self-reliance has become essential for Europeans. A truly joint security system may seem unrealistic, an unacceptable encroachment on national governments' sovereignty, but in fact 'most of the countries of Europe, constrained by history or by their own leader, have long ago

¹⁴² Dominique David, *op. cit.*, p. 7, and Peter J. S. Duncan, 1990, *op. cit.*, pp. 88-89.

¹⁴³ S. Pechurov, 'Razvitie obstanovki v Evrope i Rossii', *MEMO*, no. 4, 1993, p. 128.

let their power of defence slip on to others' shoulders'.¹⁴⁴ Clearly there remain many problems to be ironed out, for example the unprecedented establishment of a truly multilateral military command, although it must be remembered that in the past the main factor preventing such a joint leadership in the Atlantic alliance was American insistence on keeping control.

Thus the vacuum created in the East by the disappearance of the Soviet military presence in Eastern Europe, and the virtual collapse of law and order in much of the FSU, was mirrored in the West, albeit to a far lesser degree, by the decreasing American military presence in Europe. A new security architecture is called for to fill these voids. Paradoxically, the greatest threat now is not Russian power, but Russian weakness. It is the new dissolution of authority in some ex-Soviet as well as Russian autonomous republics, combined with ethnic rivalries, which most urgently require a mechanism to minimize loss of life, and prevent attempts at national expansion such as have been experienced in the Former Yugoslavia.

The threat of the latest Balkan War being replayed in the FSU on a much greater scale is a real possibility. Russia's involvement in its so-called 'Near Abroad', in other words the former Soviet states, can now be taken for granted, and more recently the bloody intervention in Chechnia has shown the fragility of peace in some areas of Russia itself. Increasing the role of international bodies in such situations could have saved very many lives. For a long time, the nature of Russia's intervention was much more careful. Apart from Moldova and Tadzhikistan, Russia's involvement in armed conflicts in its neighbouring states had been restrained and covert, until Chechnia. As mentioned in the last chapter, this was at least in part due to a fear of Western cooperation being sharply curtailed in retaliation. However, Russia's patience, and subtlety, had run out by the end of 1994. Still, although its implementation would be much more difficult now, the theoretical need for a pan-European security structure is as great as ever.

¹⁴⁴ 'La plupart des pays d'Europe, contraints par l'histoire où leur propre chef, ont depuis longtemps fait glisser sur d'autres épaules leur pouvoir de défense' — Dominique David, *op. cit.*, p. 1.

Before trying to identify the potential role of existing organizations in a new European security structure, it is essential to first define what we now mean by 'security', as this has altered in the West just as it has in Russia. In the last decade, security has become an issue no longer concerned purely with defence matters, but also needing to deal with a whole array of non-military threats to Western Europe which have been exacerbated by the instability and poverty in the former Soviet Bloc. European security now includes not only avoiding nuclear and chemical proliferation, the protection of minorities from mistreatment, and so forth, but also minimizing the threat of economic and social frustration, of violent nationalism, and the problems of military restructuring and conversion.¹⁴⁵ In particular, the risk of nuclear accidents, of mass migration, and of water and air pollution are all issues which the builders of a new European security structure must now take into account.¹⁴⁶

This contemporary concern with non-military aspects of security, or 'soft defence', vastly increases the potential for EU involvement in the construction of a European safety framework. Indeed, Brussels is already a major player in many of these fields, and in many cases this should remain the case, in order to take advantage of already established infrastructures which could be extended to the rest of Europe. One such area may well be environmental protection. This is a field where Brussels has proved to be relatively effective within the Twelve. In 1990, the European Environment Agency was created to assist the Commission's DG XI (Directorate General for environment, nuclear safety and civil protection) to formulate and implement environmental policies, supported by an environmental and observation network extending to all countries of the EU. The Agency is already open to membership of all European countries, and its Management Board, comprising representatives of the member states, the European Parliament and the Commission, could very feasibly be altered to

¹⁴⁵ I. M. Cuthbertson (ed.), *Redefining the CSCE — Challenges and Opportunities in the New Europe*, Helsinki, 1992, p. 103.

¹⁴⁶ Peter van Ham, 1993, op. cit., p. 187.

include, perhaps even be dominated by, the institution (such as the OSCE) which would head an eventual overall security structure.

One area of environmental protection which is particularly pertinent with the FSU is that of nuclear safety. The EU has been a leader in providing specialists to secure workable power stations in the FSU, and to encourage the closure of unreasonably hazardous ones (see Chapter Four). Another important contribution of the European Community was its role in the establishment of the European Energy Charter (see Chapter Three); the potential for increasing and coordinating efforts to secure nuclear plants in the East has not been fully exploited, and the European Energy Charter, with continuing support from the EU, may well be the organization to carry this through.

The threat of massive migration from East to West is also one which the EU is tackling, albeit very indirectly so far; it would be unrealistic to expect the West Europeans to entrust their immigration policies to any other international body — the shift from national to EU control is proving sufficiently problematic. Russia, however, could be persuaded to join an EU-designed immigration policy if it means greater access to the EU labour market for its citizens. Again, such an extension of EU policy would require some institutional adjustment, in this case perhaps adding joint EU-EEA or EU-OSCE sections to all the relevant Directorates-General in the Commission, or establishing a specially-designed joint immigration agency, still using much of the equipment, staff and information developed originally by Brussels. Such a development could be part of the realization of the eventual free trade agreement.

In the above sectors there is a very strong case for the EU to play a central role in a new unification of Europe's East and West, but in more defence-orientated matters, the direction now being taken by the EU is unlikely to be extendable to the FSU. Being part of the European Union not only equates to a commitment to a common foreign and security policy, but it also increasingly appears that the Western European Union will provide the EU's armed forces from 1996, when the Union is expected to alter its own constitution to include

defence.¹⁴⁷ The Western European Union (WEU) was established in 1955 by the Six plus Britain, to coordinate the defence policies of its members and to further cooperation in political, social and legal matters. After the establishment of the European Community, the WEU gradually became the 'European pillar' of NATO, remaining very much under the latter's control. The 1990s have brought a change to the WEU's role, however. First of all the Maastricht Treaty granted a dual role to the WEU, providing for it to be the EU's military arm whilst retaining its role in NATO.¹⁴⁸ At the NATO summit in January 1994 the WEU shifted further towards being a truly European organization, when it obtained the right to mount operations without the involvement of the USA, although Washington's approval would still be needed.¹⁴⁹ Soldiers from the so-called 'Eurocorps', originally set up by France and Germany and since joined by Belgian, British, Dutch and Spanish contingents, have been made available to the WEU. Yet although the WEU is being moulded with peacekeeping in Eastern Europe in mind, the inclusion of these former WTO countries in this Union is far from certain, and that of Russia virtually impossible. The very close links with both NATO and the EU mean that unless Russia was a full member of both, full membership of the WEU would almost certainly also be out of the question. The position of the Visegrad Four is much more uncertain, although the consensus of opinion appears to be that full membership of the WEU is highly unlikely before full membership of the EU, despite the fact that associate membership has been granted to them. Even membership of the EU would not guarantee full WEU membership, however, largely because of Western fears of antagonizing Moscow. Therefore, for military security especially, the EU is only likely to be part of the pan-European solution, not the continental overlord which it is in economic terms.

¹⁴⁷ Fraser Cameron, op. cit., p. 100; also *The Guardian*, 8 January 1994.

¹⁴⁸ *The Moscow Tribune*, 9 October 1992.

¹⁴⁹ *The Guardian*, 8 January 1994.

The European Union will, nevertheless, continue to overshadow the Council of Europe. The Council of Europe, not to be confused with the EU's Council of Ministers (often simply called the European Council), developed from the Congress of Europe, held under the aegis of Churchill in The Hague in May 1948.¹⁵⁰ Many of its original goals of economic and political cooperation in Europe, and of partial sharing of sovereignty, were subsequently fulfilled by the EC, the Council's earlier attempts to build a framework of integration and burden-sharing having failed.¹⁵¹ At the end of the 1980s, the Council of Europe saw a certain revival, as it played a new role as bridge between Western and Eastern Europe, and by 1991 it had created 'special guest' status for the countries of Eastern Europe and the European countries of the FSU.¹⁵² Overall, the Council of Europe's main role has been as a keeper of standards of human rights amongst all nations with a claim to call themselves European. Its main achievement is the establishment of the European Convention of Human Rights, which is upheld by the European Court of Human Rights. An important issue in the last few years has been how to extend the influence of this code of conduct to European parts of the FSU. In 1993, the Council of Europe's Parliamentary Assembly called for the establishment of an interim mechanism for the protection of human rights in states participating in the CSCE, but not yet members of the Council of Europe, and for Council of Europe member states to provide the necessary funding (estimated at \$30m *p.a.*).¹⁵³ Earlier suggestions included the possibility for such states to request the opinion of the European Court of Human Rights, and for them to invite the European Committee for the Prevention of Torture and Inhuman or Degrading Treatment or Punishment to visit places of detention in their countries. Participation in the European Convention of Human Rights, however, has been judged against, as the countries concerned would not

¹⁵⁰ Peter van Ham, 1993, *op. cit.*, p. 26.

¹⁵¹ Anna Wallace and Helen Michalski, *op. cit.*, p. 4.

¹⁵² Lucio Levi, 'Considerations on the European Community and the New World Order', *The Federalist*, vol. 33, no. 1, 1991, p. 13.

¹⁵³ *Parliamentary Assembly of the Council of Europe — Recommendation 1219 (1993) — on establishing a mechanism for the protection of human rights in European states not members of the Council of Europe.*

be affected by the European Court's ultimate weapon, namely loss of membership of the Council of Europe.¹⁵⁴ The Council of Europe has also played a role in establishing common parameters in many fields which already affect both sides of Europe. By the autumn of 1993, Russia had adhered to or signed eight of the Council of Europe's 143 conventions.¹⁵⁵ Most such international standards of quality, however, are dealt with by the EU as an essential part of controlling the single market. In the sphere of human rights, especially when dealing with violations on a large scale, the activities are largely duplicated by the CSCE, although without the support of the European Court of Human Rights. What role could be left? There have been suggestions that the Council serve as a 'political antechamber' to the EC,¹⁵⁶ but this role now seems more likely to go to the European Economic Area (Mark II). Perhaps the most interesting idea has been to find ways of associating the framework of the Council of Europe and of its Assembly with parliamentary debates in the EU which clearly affect the whole of Europe;¹⁵⁷ a similar concept, noted by the Commission but not involving the EU, is for the Council to regularly organize meetings of the heads of European states, either through a conference of European states meeting at the invitation of the European Council, or perhaps even in the framework of a confederation based on the Council of Europe.¹⁵⁸ In fact, however, the Council of Europe is extremely unlikely to become the basis for a continental security or political structure. In terms of political and economic integration it is dwarfed by the EU, and in terms of military potential or acceptability to Russia, it is eclipsed by the CSCE. Not the least of the Council of Europe's problems are the unclear boundaries of its mandate. Even the Council of Europe's Parliamentary Assembly has recognized

¹⁵⁴ *Parliamentary Assembly of the Council of Europe — Recommendation 1183 (1992)*.

¹⁵⁵ *Chart of Signatures and Ratifications of European Treaties*, Directorate of Legal Affairs, Treaty Section, Council of Europe, 5 November 1993 update; the European Conventions concerned are: Cultural; Protection of Archaeological Heritage (both original and revised versions); Spectator Violence at Sports Events and in Particular at Football Matches; Protection of the Architectural Heritage of Europe; Anti-Doping; Protection of Animals During International Transport; additional protocol to the latter; Information on Foreign Law.

¹⁵⁶ Anna Wallace and Helen Michalski, *op. cit.*, p. 23.

¹⁵⁷ *Ibid.*, p. 66.

¹⁵⁸ From a report from the EC Commission to the European Council, Lisbon, 24 June 1992, in Graham J. L. Avery, *op. cit.*; EC Doc., 24 June 1992, in *Biblio post-Maastricht*, no. 7, 1992.

this, calling in 1992 for measures to improve the knowledge amongst CSCE participating states about Council of Europe activities in order to avoid duplications, waste of resources and possible conflicts.¹⁵⁹ It is particularly essential for the Council of Europe and the CSCE to clarify, coordinate, and possibly even amalgamate their respective actions and policies on human rights, if the Council of Europe is to maximize its effectiveness in what is its most important field.

The organization with the most experience of trying to ensure security in Europe, and the mentor of the EU's own embryonic defence organization, is the North Atlantic Treaty Organization (NATO). NATO is of obvious importance to the future of cooperation between Russia and Western Europe; an overly aggressive policy on the part of the Atlantic Alliance could easily derail the movement towards closer relations with the EU, whilst a policy of restraint and compromise could achieve the opposite. The creation of NATO was sparked off by the Soviet blockade of Berlin in 1948-49,¹⁶⁰ and until the late 1980s its *raison d'être* remained to defend the West from the Soviet threat. With the great reduction in this menace by the late 1980s, the purpose and even the future of NATO were in doubt. One of the suggestions, for example by the then US Secretary of State James Baker in Berlin on 12 December 1989, was to assign new, non-military tasks to NATO, including the building of new economic and political ties with the East, promoting respect for human rights, helping to build democratic institutions, and so forth.¹⁶¹ This proposal met with much opposition. Ian Davidson, for example, argued that NATO was neither equipped nor experienced enough to do this, and should instead simply accept a reduction in its role, as the price for remaining 'alive and functional' as before, even if this meant weakening the main American lever in East-West European affairs. Yet despite a lack of experience at

¹⁵⁹ *Parliamentary Assembly of the Council of Europe — Recommendation 1184 (1992) — on the work of the CSCE on the eve of the Third Summit (Helsinki, 9-11 July 1992).*

¹⁶⁰ John Lewis Gaddis, *Russia, the Soviet Union, and the United States: an Interpretive History*, New York, 1978, pp. 190-92.

¹⁶¹ Ian Davidson, *op. cit.*, p. 282.

a cooperative rather than defensive approach, NATO has been the most active and effective institution so far in drawing up a new security arrangement. The fact that NATO no longer has a counterpart in Eastern Europe has not prevented it from seeking alliances there, and succeeding. This could mean that it is only a matter of time before NATO (or one of its new creations) takes on a political aspect, especially if other European institutions fail to do so on a continental scale. It was noted in the last chapter how even in Russia there has been the odd suggestion that as only NATO has come up with an adequate security plan, it would be the only sound basis for a defence system for the whole continent;¹⁶² the establishment of NACC at first seemed to confirm this. The North Atlantic Cooperation Council brought together all the former members of the WTO and the signatories of NATO, aiming to enhance military consultation, and to cooperate in military planning, civilian management of the military, disarmament and conversion, air traffic control, and civil emergency planning. In 1992, NACC had also established an *Ad Hoc* Group on Cooperation in Peacekeeping, which included representatives from the CSCE and from non-NACC CSCE countries.¹⁶³ In fact, though, NACC turned out to be insufficient, largely because it was not offering membership, protection nor even a strategy to tackle violent conflicts in the former Eastern Bloc. The Visegrad Four in particular kept pushing hard for closer association with, and eventual membership of, NATO. We have seen already, however, that by the end of 1993 Moscow was clearly against the inclusion of Eastern Europe in NATO. Attempts to appease Moscow with a separate treaty with NATO were insufficient, and the NATO leaders in the end backed down from directly offering membership to the East Europeans. The compromise that was reached in time for the January NATO summit was the 'Partnership for Peace' (PFP, or sometimes referred to as P4P). This Partnership's official aim is to adapt the military systems of many of the ex-WTO

¹⁶² S. Pechurov, op. cit., p. 127.

¹⁶³ 'Statement Issued at the Meeting of the North Atlantic Cooperation Council', at NATO Headquarters, Brussels, 3 December 1993, *NATO Review*, December 1993.

states so that they could eventually join NATO,¹⁶⁴ which is now officially stated to be a definite possibility; in the words of President Clinton, PFP 'changes the entire dialogue so that now the question is no longer whether NATO will take on new members, but when and how. It leaves the door open'.¹⁶⁵ No timetable is provided, though, precisely because of the reluctance to antagonise Moscow more than is deemed strictly necessary. Each country has been encouraged to go at its own pace.

Russia's own position *vis-à-vis* PFP has always been unique, and difficult. For a country not aiming at NATO membership, PFP offers very little more than the NACC framework within which it was created. In the event of a threat to territorial integrity or political independence, PFP merely promises consultation from NATO.¹⁶⁶ Membership of PFP provides the opportunity to establish a liaison office at NATO Headquarters, but the main incentive for joining remains the provision for gradually making a country's armed forces compatible with those of NATO, thus facilitating membership. Yet despite the realization that full NATO membership is not a realistic option for Russia in the short- or medium-term, Moscow has accepted many compromises to join the NATO Partnership.¹⁶⁷ Although the soothing effect on relations with the West will be pleasing to El'tsin, as will be the increased cooperation on conversion projects, the main reason for Russia's participation lies elsewhere. El'tsin's goal is almost certainly to delay, and perhaps even prevent, NATO expansion into Eastern Europe. In the words of Alexei Pushkov, PFP 'leaving the issue of admission open until things in

¹⁶⁴ Johnathan Sunley, 'Tasks for NATO II: Improve the Partnership for Peace', *World Today*, April 1995, p. 70.

¹⁶⁵ *The Guardian*, 13 January 1994.

¹⁶⁶ 'Partnership for Peace: Framework Document', *NATO Review*, February 1994, p. 29.

¹⁶⁷ Despite this agreement to join the Partnership for Peace in general, signed in the summer of 1994, the issue of NATO expansion remained a serious bone of contention between Russia and the Atlantic Alliance, and was used as the reason for Foreign Minister Kozyrev not signing two programmes which came under PFP and formed the core aspects of it; namely, commitment to ambitious programmes of military cooperation with possible joint peace-keeping operations. These two programmes were finally signed in late May 1995, when Russia apparently felt more confident about the fact that NATO expansion would not occur in the near future; from *The Guardian*, 2 December 1994, 6 December 1994 and 31 May 1995.

Russia become clearer, best suits both the West's and Russia's interests'.¹⁶⁸ There were clear signs of Russia's anti-expansionist stance during the negotiations for PFP, when El'tsin's representatives objected strongly both to a reference to PFP's role in the expansion of NATO, and, of particular interest to the EU, to the mentioning of the associate status granted by the WEU to East European and Baltic states.¹⁶⁹ Statements in the press declaring that Moscow no longer opposed NATO expansion were probably a severe misinterpretation; what Andrei Kozyrev actually said was that 'We do not preclude the possibility that we or other countries should join NATO, but there is no haste'.¹⁷⁰ This could just as easily be taken to mean that East Europeans will only be allowed into NATO when Russia is offered membership, in other words not for a very, very long time.

It was never probable that a NATO-based structure could be the solution for a united Europe, considering Russia's apprehensions about American supremacy. PFP and NACC, being derivatives of NATO, remain to a very large degree in Washington's control. This was made clear during PFP negotiations in the spring of 1994, when the American Ambassador to NATO replied to Russian requests for a different status from that of the East Europeans by saying that 'the partnership itself is on the basis of equality of opportunity.' He added that 'outside Partnership for Peace we would be pleased to talk to them about how one could have consultative mechanisms [...]. But we wanted to make very clear that NATO takes its own decisions'.¹⁷¹ Thus the author believes that hopes for a true solution remain outside PFP.

The Americans have also stressed the possibilities outside PFP, the Secretary of State, Warren Christopher, stating that dialogue on nuclear disarmament, strategic doctrine and counter-proliferation were potential topics for what he called 'Sixteen plus One' consultations.¹⁷² Such consultations, though,

¹⁶⁸ Alexei Pushkov, 'Russia and the West: an Endangered Relationship?', *NATO Review*, February 1994, p. 23.

¹⁶⁹ *The Guardian*, 11 June 1994.

¹⁷⁰ *SWB*, SU/2030, 24 June 1994 — taken from World Service, Moscow, in Russian, 22 June 1994, B/7; also *The Guardian*, 23 June 1994.

¹⁷¹ *The Guardian*, 7 March 1994.

¹⁷² *The Guardian*, 10 June 1994.

would not satisfy Moscow's need for a more active role in European security. In other words, if Russian membership of PFP is to have any significant effect, it is most likely to be this structure's stagnation, rather than allowing NATO to lead the direction of Europe's new security arrangement. This will probably only change when Moscow obtains what it failed to acquire in negotiations over PFP — a wider organization, of which both the CIS and NATO are constituent parts, and which is not controlled in Washington. NATO foreign ministers have themselves in the past declared that Eastern Europe should concentrate on the CSCE and the EC,¹⁷³ and this still appears to be the most sound solution, short of developing a new structure altogether.

It is the CSCE which Moscow has most often specified as the organization which should have overarching control over all the security organizations operating in Europe, including NATO. This was put forward as a pre-condition for Russian adherence to PFP when Defence Minister Grachev visited the NATO headquarters in May 1994, and only in the very last stages of negotiations, after NATO unambiguously refused any degree of subordination, did the Russians back down. Nevertheless, Kozyrev concluded a speech on the day he had signed PFP (in principle) by declaring that the main aim was 'to direct every effort towards the formulation of a single Europe in which the main role, NATO and Russia were agreed, would go to the CSCE'.¹⁷⁴

The European Union would have much to gain if Washington could agree with Moscow on a security coordinating and controlling role for the CSCE throughout Europe. The EU's links with the Helsinki Process already go very deep, and the European Parliament's readiness to participate has been particularly noticeable. Not only was Brussels of importance in the original Conference, but the EU also encouraged the CSCE, starting at the 1984 Venice meeting, to assist in encouraging economic and environmental cooperation throughout the

¹⁷³ *The Guardian*, 16 February 1991.

¹⁷⁴ *SWB*, SU/2030, 24 June 1994 — taken from World Service, Moscow, in Russian, 22 June 1994, B/7.

continent. In 1987, the European Parliament passed a motion stating that the CSCE process was the most appropriate instrument for a European policy of détente, and it called for an integration of members' security interests into EPC. It was hoped that this would enable the EC to be on an equal standing with Washington and Moscow at future CSCE conferences,¹⁷⁵ rather than concentrating purely on economic and human rights aspects of the Helsinki Process, as EPC had done so far. Although this level of involvement was not supported by the European Council, the Dublin Summit of June 1990 did nonetheless reaffirm the important role played by the CSCE in the process of change in Europe, and it was stated that the EC should continue to play a leading role in the CSCE.¹⁷⁶ Meanwhile the Parliament continued to be more enthusiastic about the CSCE, calling (in 1990) on the foreign ministers at the forthcoming CSCE meeting to promote an initiative for political cooperation with the countries of the former Eastern Bloc, to be pursued in close cooperation with the Commission of the EC and the European Parliament.¹⁷⁷ The MEPs went further still in 1993, resolving that,

the EC must use its influence in the CSCE in particular to seek a solution to all the conflicts between and within the countries of the FSU before they spiral out of control and trigger off crises of international dimensions posing a threat to world peace and stability.¹⁷⁸

In particular, it was stated that reform of the political and legal systems in the FSU could be helped by the Council of Europe and the CSCE (through its Office of Democratic Institutions and Human Rights), and that the Parliament believed that the CSCE process must be backed up by arbitration arrangements as a way of helping to resolve the intractable conflicts bedevilling parts of the FSU.¹⁷⁹

¹⁷⁵ European Parliament Document, *EP Doc A 2-26/87*, pp. 5-8.

¹⁷⁶ Fraser Cameron, op. cit., p. 97; also *Background Report — The European Community and the Conference on Security and Cooperation in Europe, in View of the Helsinki Follow-Up Meeting*, EC Commission, London Information Office, 26 March 1992.

¹⁷⁷ *EP Doc. B3-0664/90*.

¹⁷⁸ *EP Doc. A3-0201/93*, p. 5.

¹⁷⁹ *Ibid*.

Although the European Parliament's enthusiasm for an increased role for the CSCE has only partially been translated into action by the Council and the Commission, there is nonetheless a solid basis of cooperation already in place upon which to build the joint structures to deal with pan-European environmental and emigration problems suggested in the above paragraphs on the EU. The guidance and support of the EU would be an invaluable asset to the CSCE in its transition to an eventual leading role in European security, providing that the CSCE has its own financial backing to avoid depleting Brussels' already stretched resources. In already combining at least some aspects of political, social, economical as well as military security, the CSCE has a head start over NATO.¹⁸⁰

The EU Council's failure to push for a strong security role for the CSCE goes against the advice of some West European specialists. One main reason for this support of the CSCE is that it is not based on the old framework of conflicting alliances. The fact that the Helsinki Process is not overwhelmingly dominated by the USA not only makes it more attractive to Russia, but also provides the potential for Europeans to acquire a greater ability to determine their own future defence policy. A shift away from the previously high level of dependence upon American military support in Europe is not a new requirement; by the mid-1980s, the Western security alliance had come to a severe conflict over burden-sharing.¹⁸¹ As the level of military might needed in Western Europe has declined with the immediacy of the Russian threat, the feasibility of European states accounting for a greater proportion of this defence capability has increased. Conversely, the fact that the Americans are an important part of the CSCE is also a blessing. Although greater self-determination in European security is desirable, the prospect of being devoid of American military support is too perilous to be acceptable to most strategists. In part this is because the core of the military

¹⁸⁰ Charles Kegley Jr, 'Does the US Have a Role in the Future European Security System?' in *Redefining the CSCE — Challenges and Opportunities in the New Europe*, ed. I. M. Cuthbertson, Helsinki, 1992, p. 131.

¹⁸¹ Willem F. Van Eekelen (General Secretary of the WEU), 'The Future of NATO and Warsaw Pact Strategy', *The Strategic Implications of Change in the Soviet Union*, ed. François Heisbourg, Basingstoke, 1990, p. 41.

threat to Western Europe is nuclear, especially now that Russia's conventional forces are reduced and are further away; consequently, as the USA provides the most efficient nuclear deterrent, it still holds a key role.¹⁸² The CSCE is the only organization which can count on some degree of American protection, without being subject to overwhelming American control. Yet it is not simply American domination that the CSCE could help discourage. One common concern is that if Russia is included in a European structure, it would then inevitably dominate it, and that if it is not, Germany would then have an inordinate amount of influence. A CSCE-based structure could balance out the strength of these three powers.

Another strength of the CSCE process is that, from its very inception, it has been concerned not merely with international affairs, but also with violence and attacks on human rights within countries, thus challenging the traditional taboo on interfering in another country's internal affairs. This strong leaning of international law towards problems in interstate relations, not those within states, is a major reason why the crisis in Former Yugoslavia could not be solved sooner. The Paris Charter of 1990 and the Helsinki Document of 1992 explicitly stated that human rights are a 'matter of direct and legitimate concern to all participating states and does not belong exclusively to the internal matters of the state concerned'.¹⁸³ The CSCE could, if supported adequately by all sides, be in a good position to develop its experience in encouraging governments to feel accountable to the international community in their treatment of minorities or of the opposition, especially if the European Parliament's suggestion of an effective arbitration system can be realized.

Probably the best reason for concentrating on the CSCE as Europe's overall defence framework is that it is the one most suitable for translating Russia's desire for assistance with its defence objectives into international leverage and interdependence. As mentioned earlier, the high cost of large-scale military involvement in conflicts in neighbouring states is a great worry to Moscow.

¹⁸² Dominique David, *op. cit.*

¹⁸³ Michael Mihalka, *op. cit.*, p. 3.

Although it is by no means clear what level of Western involvement could be negotiated in exchange for financial support, Moscow certainly understands that it will not be without its price. At the very least teams of monitors should be sent, whose reports will determine whether financial support should continue. In theory, if proposals were carefully designed with adequate consultation, a system of joint forces, and some level of joint decision-making, might be made to work. Debates along these lines have already been taking place, Washington for example coming up with 'Directive 13', which called for external help in the resolution of conflicts between states of the FSU by the UN, the CSCE or perhaps even NACC; this directive attracted much criticism from the USA's NATO allies, however.¹⁸⁴ There are, indeed, many potential pitfalls. The experience of the early stages of the military intervention in Chechnia, however, has shown the El'tsin administration was then not willing to risk either opposition from anti-Western forces in Russia, or a further Western outcry based on the reports of an intergovernmental organization. That lack of support for the OSCE evidently puts the entire progress of this body on the back burner, at best. Michael Mihalka may well be right in suggesting, however, that this failure to translate theoretical support for the OSCE into practical empowerment from the side of the Russian government is due in large measure to the low level of support which the OSCE commands amongst West European governments.¹⁸⁵

Even if there came to be a mutual readiness to form a truly supranational pan-European security structure, some would argue that military alliances designed to protect its members from each other can be argued to be 'plausible only if they are not really needed'. A new European security organization might fail to be more effective than previous attempts at military alliances in the Middle East or in the Balkans, even if they included the setting up of 'multiple reciprocal stationing of forces, national or multinational, by European states on each other's territories in a "reassuring" or preventative function', because if Russia again

¹⁸⁴ *The Guardian*, 19 August 1993.

¹⁸⁵ Michael Mihalka, *op. cit.*, p. 8.

became militaristic, or if Germany distanced itself from the EU and/or became aggressive towards Russia, reciprocal entanglements probably would not help.¹⁸⁶ Gerhard Wettig stressed that under a system of collective security, 'the contractual obligations taken are a mere bluff', as governments still have the freedom to apply them only as long as the benefits outweigh the costs.¹⁸⁷

Although these points should be kept in mind, reminding us that there are never any guarantees on security alliances' endurance, it can also help us to focus on how to maximize the chance of making an alliance work — making the benefits outweigh the costs. Thus the more benefits it provides for Russia, without granting it obvious supremacy in any important sphere, the more influence the OSCE (or an entirely new organization) could have as an organization.

Of course the OSCE at present has numerous failings, and is a very long way from being a continental leader or patron. In the words of I. M. Cuthbertson, 'the broad and relatively unstructured mandate of the CSCE process, which gave it flexibility during the last two decades, is now seen by some as a liability'.¹⁸⁸ Some American diplomats at the Helsinki meeting in July 1992 went further, saying that 'the CSCE is not an international organization. It is in constant change'.¹⁸⁹ The risk of insufficient support being provided by the USA for an increase in the OSCE's importance at the expense of NATO is a very serious one, but which might be overcome by a desire on Washington's part not to provoke Moscow by expanding NATO, yet wanting another structure to cover Eastern Europe. 'Directive 13', despite being arrogant in tone, showed the first (albeit untypical) signs of American willingness to grant an important security role to the Helsinki Process.

Despite the OSCE not yet being a very powerful body, at least it is a long-established one. The Paris Summit in 1990 made a CSCE *organization* out of

¹⁸⁶ Pierre Hassner, 1990(ii), op. cit., p. 468.

¹⁸⁷ Gerhard Wettig, 'Security in Europe: A Challenging Task', *Aussenpolitik*, English edition, vol. 43, 1992, no. 1, p. 5.

¹⁸⁸ I. M. Cuthbertson (ed.), op. cit., p. 3.

¹⁸⁹ Gerasimos Turukis, 'Evropa v poiskakh novogo ustroistva', *MEMO*, no. 5, 1993, pp. 91-99.

what was formerly merely a CSCE process, and at the 1992 Review Conference in Helsinki, the Belgian government's proposal that the CSCE become a collective regional security organization under chapter eight of the UN Charter was approved.¹⁹⁰ There have been more concrete developments, with the CSCE Office of Democratic Institutions and Human Rights (ODIHR) opening in Warsaw, the Conflict Prevention Centre in Vienna (there have been suggestions to merge these two bodies together), and the CSCE Secretariat in Prague. The Helsinki Summit also saw the establishment of the post of High Commissioner on National Minorities.¹⁹¹ The creation of a stronger Court of Arbitration and Conciliation is still being discussed. At the CSCE Summit in Budapest in December 1994, the Conference was officially renamed the Organization for Security and Cooperation in Europe (OSCE). This change is seen as being merely cosmetic, as operationally the organization remained the same. This was also the Summit where Russia failed to persuade its West European partners to increase the role of the OSCE, as partially explained above. The main objection that the Western members had was that if the CSCE was to become the coordinator of all security bodies operating in Europe, Russia would be likely to obtain a veto over NATO activities in CSCE areas.¹⁹²

The CSCE was often criticized for having failed to react adequately to the escalation of war in the former Yugoslavia, but when violence erupted in 1991 it had no institutional capacity to deal with it; the Conflict Prevention Centre had only been open a few months, and its brief was to deal with interstate rather than intrastate conflicts, contrarily to that of the ODIHR.¹⁹³ More importantly, of course, it suffered from the same lack of political support for intervention as did NATO and the WEU, a fact deplored by the CSCE Parliamentary Assembly in July 1993.¹⁹⁴ Nevertheless, the CSCE has sent observer missions to conflict areas of the Balkans and of the FSU, and has established on-site missions in Estonia,

¹⁹⁰ Charles Kegley Jr, *op. cit.*, p. 131, and Fraser Cameron, *op. cit.*, pp. 98-99.

¹⁹¹ Konrad J. Huber, *op. cit.*, p. 12.

¹⁹² Michael Mihalka, *op. cit.*, pp. 4-6.

¹⁹³ Konrad J. Huber, *op. cit.*, p. 12.

¹⁹⁴ *Helsinki Declaration of the CSCE Parliamentary Assembly*, 9 July 1993, p. 6.

Abkhazia, Macedonia, Kosovo, Sandzak and Vojvodina (the last three are in the rump of Former Yugoslavia). All in all, however, it has had to concentrate on monitoring and prevention of potential conflicts; one particularly successful instance was the intervention of the High Commissioner on National Minorities in Estonia, which, combined with pressure from the Council of Europe, helped to persuade the government to alter the proposed constitution in the interests of the rights of the Russian minority.¹⁹⁵

Clearly, though, there is much restructuring of the OSCE to be done if it is to assume a European UN-type role. Many serious suggestions have been put forward, some of which show the influence of the EU as successful precedent worth following. The growing importance of the OSCE's Council of Ministers, and the annual summit of OSCE heads of state are examples of the emerging EU-type decision-making structure. The OSCE's Parliamentary Assembly has also requested that the Council of Ministers set up a Council of Permanent Representatives with headquarters in Vienna, with the task of preparing for meetings of the Council, implementing and following up the decisions of the Council,¹⁹⁶ thus playing the role of both the Commission and COREPER (Committee of Permanent Representatives) in Brussels. The need to reform important voting majorities is even more essential in the OSCE than it is in the EU. Although consensus-minus-one has been accepted in cases of blatant violations of human rights, there have been wide-spread calls for an acceleration of the decision-making process; the Parliamentary Assembly singled out the need to abandon consensus-minus-one, presumably for a system of QMV similar to that of the EU's Council. The Assembly also invited its Council of Ministers to consider setting up a CSCE security committee, based on an annual rotation system between representatives of Member States which would examine all subjects relating to peacekeeping and peace enforcement;¹⁹⁷ this could become the OSCE's equivalent of the UN's Security Council.

¹⁹⁵ Konrad J. Huber, *op. cit.*

¹⁹⁶ *Helsinki Declaration of the CSCE Parliamentary Assembly*, 9 July 1993, p. 16.

¹⁹⁷ *Ibid.*, p. 17.

For the OSCE to develop a real peacekeeping and peace enforcement capability, the relationship between it and the bodies providing troops must be clarified, and the OSCE's position strengthened. The providers of the OSCE's military resources could be divided into four main groups: the Western European Union; non-WEU members of NATO (this may include countries such as the UK and Denmark, who may become excluded from the WEU if their commitment is insufficient); East European states; and the CIS. The first steps towards such an arrangement were taken in July 1992, when the CSCE was empowered to call upon NATO, the WEU and others to help with peacekeeping.¹⁹⁸ If ever such a system of coordination and control of peacekeeping and peace enforcement in Europe was achieved, NATO would inevitably retain a higher status, as an 'elite' section of the CSCE's forces, with its higher technology used to the assistance of, but not shared with, the other CSCE groups. The decision-making structure of each individual military grouping could decide to decline involvement in any particular conflict. Any proposed peacekeeping or enforcement mission would need the approval of the CSCE's security committee to take place; disobeying CSCE rulings could result in sanctions and/or loss of CSCE membership.

The abolition of the need for consensus in the CSCE Council, as suggested above, would solve the main objection used by the USA to subordination of NATO to the CSCE, namely that Russia would be given a veto over NATO activities, as long as the Council could overrule decisions by the security committee (unlike the UN's Security Council).

At the Helsinki summit in 1992, the German government proposed the establishment of a permanent and easily accessible CSCE force, the 'Green Helmets', responsible both for peacekeeping and environmental protection.¹⁹⁹ Eventually, the CSCE could have developed a truly multinational military command, with a level of integration nearing that which NATO has at present, although in the meantime NATO would most likely retain the role of coordinator

¹⁹⁸ *The Financial Times*, 27 November 1993.

¹⁹⁹ Fraser Cameron, *op. cit.*, pp. 98-99.

in any major interventions. There should be clearly defined stages making this process of integration a gradual one, with every stage being conditional upon adherence to the principles this whole structure is designed to upkeep.

It must be recognized, however, that the scenario depicted above is very unlikely to be realized. For any real increase in the power of the OSCE to take place, there is a need for a level of initiative and foresight which is lacking amongst present politicians in Europe. West European powers, writes Stefano Silvestri,

while engaged in a 'reformist' process of European integration, have a strong 'residual' interest in the maintenance of the present international system and share with the major powers the distrust and the fear of 'new' solutions which might endanger their strength.²⁰⁰

More recently, we have also seen that Russian support for the OSCE at the moment is much greater in theory than in practice, at least so far as involvement within the FSU is involved.

Even before war broke out in Chechnia, despite the many statements about the desirability of a stronger role for the CSCE, in June 1994 Moscow rejected a CSCE proposal which would support 'third party' (not CSCE and not UN) peacekeeping operations, because they would have to be subject to scrutiny by CSCE monitors. The EU, again showing a very united stance in CSCE negotiations, complained of the Russians wanting any monitoring to be merely symbolic. It seems, however, that monetary support for Russian peacekeeping was not part of these negotiations. There is still an outside chance that if the price is right, CSCE monitoring might become acceptable.

This does not make for a promising future. It now seems likely that within a decade the inclusion of Eastern Europe into a NATO-based structure will have resurrected a Cold War mentality between NATO and non-NATO members, and that whichever way the East Europeans fall, Europe will again be divided, and

²⁰⁰ Stefano Silvestri, 'The New World Order: Too Good to be True?', *The International Spectator*, vol. 26, no. 4, October-December 1991, p. 31.

again more dangerous. The EU should increase its efforts to work on soft defence issues, in some areas by itself and in others with the OSCE, and to find a mutually acceptable, very possibly OSCE-based solution to the lack of military cooperation in Europe, and to the threat of a new split. Inevitably, whilst the Russian government is close enough to the Slavophile pole of foreign policy to allow full-scale warfare to take place on its territory, whilst allowing only negligible West European involvement, no real progress can be achieved in the establishment of a new European security structure. As soon as the Russian governmental position changes back to a more conciliatory position, however, all the above arguments will have to be considered.

2.8 Conclusions

Although the full integration of Russia into the EU is not seriously at issue, nor will it be in the foreseeable future, the level of cooperation and interdependence which can be secured between Brussels and Moscow will nonetheless be of decisive importance in determining Russia's future openness to the West as a whole. This is in part due to the intrinsic economic and political gains which could potentially stem from the signing of the Partnership Agreement, and in part because of the precedent established through accords with the EU, which opens the way for closer interaction with other European and international organizations.

Despite the discrepancies in individual EU states' approaches to relations with Russia, in particular France's fear of decelerating integration, Britain's determination to do precisely that, and the Mediterranean states' fear of losing out to Russian import competition, the Partnership Agreement shows that enough compromise can be reached to encourage closer commercial and diplomatic exchanges between Moscow and Western Europe within an EU framework. The signing of the Maastricht Treaty has also shown the high level of consensus still

possible in the Union, and makes likely an even greater degree of coordination in EU foreign policy, as well as a more prominent role for the European Parliament. The result may eventually be an increased ability to pursue more enthusiastic and far-sighted policies towards Russia.

The process of *rapprochement* between the EC and the USSR was strongly dominated by Soviet initiatives and control by Brussels over what should be included in agreements between the two sides. This shows both the relative economic weakness of the USSR/Russia in relation to the EC/EU, and the greatly increased importance of economic might and competitiveness in contemporary international relations. However, the lack of a need to initiate or to push for consensus has also meant that Brussels has offered much less not only than Russia wanted in their mutual accords, but also less than many specialists saw as desirable to increase Russian goodwill towards Western Europe. The shift away from Westernist policies can be attributed in part to the insufficiently generous terms, especially in trade restrictions, offered by the EU to Russia. Negotiations over the Partnership Agreement demonstrated that the greatest stumbling blocs between both sides were over protection of the EU market, most notably in chemicals, non-ferrous metals, nuclear fuels and satellite launchings. The Council and Commission would have done well to heed the criticism coming not only from Moscow, but also from its own Parliament and many specialists, suggesting that the benefits to bilateral relations of freeing trade in these areas would far outweigh the damage done within the EU, especially considering Russia's very limited ability to increase exports during its chaotic transition period.

The initial signing of the Partnership and Cooperation Agreement (and eventual signing of the Interim Agreement which enacted the commercial clauses of the Partnership Agreement — see Postscriptum) is nevertheless of great importance. On the political side, the bi-annual summits put in place by the Agreement are an important vehicle through which to achieve still closer interaction and mutual understanding; it is significant that this is the very same

mechanism which the EU uses for its high-level contacts with the USA. The establishment of an official framework for technical assistance and for cooperation in a vast number of cultural and scientific areas is also valuable. On the commercial side, recognizing Russia as being an 'economy in transition' rather than a centralized economy, in terms of decreased liability to anti-dumping, was a very important concession. The prospect of a free trade area extending to Russia is clearly the most remarkable aspect of the Partnership Agreement; what remains to be seen is the extent to which Brussels is committed to its realization, and how many 'special' areas of restricted trade will survive. A detailed study is needed of the expected levels and benefits of trade and economic interdependence which would result from Russia's inclusion in a new EEA.

It has been shown that the EU has a vital part to play in pan-European security, not least because the definition of security itself has changed in the last decade. Primarily, the EU's direct role should lie in 'soft defence' areas such as environmental protection, human rights, poverty and migration control. The EU's experience, staff and infrastructure should be extended to the rest of Europe, very possibly with the help of the OSCE. As its own WEU is inappropriate for FSU membership, and as a NATO-based structure is most likely to eventually be divisive, the EU should also unite in insisting on a greater role for the OSCE, or alternatively a new security organization, in coordinating and controlling peacekeeping and peace enforcement operations, as well as military pacts, throughout the European continent.

The problems with the establishment are enormous, and have become even more so after the war in Chechnia and Russia's own lack of support of OSCE activity in the FSU. Nevertheless, the dire need for a new security structure to be set up in Europe is obvious, as is the desirability of including Russia in that structure, lest Europe again be neighboured by an unfriendly superpower. A better balance between granting Russia a voice in Europe's security organization which reflects its size and power, yet does not allow it to paralyze the rest of the continent's ability to act against Moscow's interests if Russia stands alone, is the

necessary goal. Without a mutually acceptable solution to the security question, the economic and political agreements between Russia and the EU rest on unstable ground.

Chapter 3: The Effect of Russian Economic Reforms on Foreign Trade, and on the Prospects of Closer Russia-EU Economic Relations.

3.1 Introduction

The importance of commercial interaction between the European Union and Russia is critical; although the political aspects of the relationship are the main concern of the EU, Russia is largely concerned with the economic sides of this partnership. As explained in the first chapter, Russia's inability to compete either commercially or technologically with the West whilst maintaining a centralized and isolated economy was the major reason for Gorbachev's *perestroika*. The main aim of this chapter is to determine what progress has been achieved by Russia in opening up its economy to trade and investment from the West, and to examine whether the degree of interdependence between the EU and Russia has increased.

To do this, the first section of this chapter aims to give an outline of the factors which will determine in which sectors trade and investment with Western Europe can be expected to grow, and to what extent. After an assessment of the significance of foreign trade for Russia, there follows a background section on the economic problems inherited from the Soviet system. The focus then moves to Gorbachev's attempts to revolutionize Moscow's approach to foreign trade and investment, and what was left to El'tsin to tackle in this field. The new Russian President's successes and failures in areas most relevant to foreign trade and investment are then examined: macrostabilization; price reforms; privatization; tax regime; legislative structure and investment protection; and foreign trade *per se*. Russia's ability to attract foreign investment is compared to that of some of the other states who have reformed Communist economic systems. Finally, the

main achievements are emphasized, as are the most important failings which must be tackled if Russia is to become an integral part of the European economy, without threatening the Western part of the continent. Appendices on the energy and aeronautics industries are added at the end of the thesis to provide a more detailed study of the opportunities for Western involvement in two of Russia's most promising sectors, and to give concrete examples of the areas in which Russian industry is most dependent on Western technology and know-how.

3.2 The Former Soviet Economy in Terms of European and World Trade

Soviet trade with the rest of the world, especially with the non-socialist countries, was traditionally seen as small in relation to the size of its economy. Unfortunately, Soviet statistics on this cannot be regarded as adequate, as they compare external *valuta* rubles to domestic or intra-CMEA prices, whilst the prices inside and outside the ex-USSR were not comparable, nor were the quality of the commodities they could purchase. Foreign trade figures in *Vneshniaia trgovlia* used to be presented in so-called 'foreign-trade' rubles, representing the prices in foreign currencies actually received or paid by the USSR, converted to rubles by means of an officially set exchange rate. These prices in *valuta* rubles were then converted into domestic rubles using 'differentiated convertibility coefficients' (DCCs, often known by their Russian acronym — DVKs), of which there were approximately two thousand,¹ with ratios to foreign trade rubles of anything from 0.2 to 10.0.² Domestic prices of imports therefore joined prices of locally produced goods in being entirely unreflective of world prices.

¹ Franklyn D. Holtzman, 'Moving Toward Ruble Convertibility', *Comparative Economic Studies*, vol. 33, no. 3, 1991, p. 37.

² Vladimir G. Trembl, 'Soviet Dependence on Foreign Trade' in *External Economic Relations of CMEA Countries: Their Significance and Impact in a Global Perspective*, NATO Colloquium 1983, Brussels, 1983, pp. 35-52; Alan Smith (1993, op. cit., p. 133) reports that DVKs (which were used directly by enterprises dealing in foreign trade after 1987, not merely used by the central authorities to present a ready-converted price for imports or exports, the so-called *preisausgleich* system, which continued to operate in parallel to DVKs after 1987) had a ratio of foreign exchange rubles to domestic rubles of 0.1 to 15.9.

The discrepancies between domestic and world prices are blatantly obvious if we look at trade figures for 1991, presented by the relatively reliable economists of El'tsin's government. Total exports from the former USSR were valued at \$70.2bn; of which \$31.8bn went to Western countries, therefore having comparable quality.³ If these dollars would have been exchanged for rubles at the non-cash Moscow International Currency Exchange in mid-January, at the going rate of Rb180 to the dollar,⁴ the value of exports to the West would have been Rb5,724bn, in other words over three times the total value of ex-USSR GDP (if the latter is taken to be Rb1,800bn, as given in the EIU report)! This shows how unrepresentative Soviet prices were, and how the ruble was still overvalued in 1991.

Thus using Soviet figures to establish the importance of foreign trade in relation to GDP is of extremely limited use. Although an IMF study of Soviet foreign trade in 1988 concluded the economy was relatively closed, as exports were only 6.8% of GDP, the two figures being measured up to each other are probably not comparable. Exports were measured in foreign trade prices, but it was not specified how GDP was calculated.⁵ It is highly unlikely, however, that it was calculated by using volumes of production of every product group and multiplying by average world prices, the only method which would have given a reasonable approximation (although still very inaccurate, due to the important discrepancies in quality). It is most likely that GDP was converted from an estimation in rubles, and was consequently very misleading. By 1993, however, Russian figures were more representative of the value of exports and imports in relation to domestic production, although still retaining a high degree of inaccuracy.⁶ Rosgoskomstat (the Russian State Committee for Statistics) and the

³ *The Economist Intelligence Unit Country Report on the CIS*, no. 1, 1992, p. 65.

⁴ *Kommersant*''', no. 3, 13-20 January 1992, p. 6.

⁵ IMF, IBRD, OECD, EBRD, *A Study of the Soviet Economy*, Paris, OECD, 1991, vol. 2, p. 68.

⁶ Even the 1993 Russian figures are very tentative, for many reasons. The main factor contributing to this distortion is that an important degree of foreign trade is not officially recorded, as importers or exporters manage to either smuggle their goods or bribe customs officials to turn a blind eye, in order to avoid tariffs and taxes; such underreporting also affects GDP figures, however, and it is impossible to tell which figure is most underestimated. Converting a ruble figure into hard currency still represents an important loss of accuracy, both because the ruble was undervalued in 1993, and

Russian Central Bank's (RCB) figures put Russian merchandise exports (outside the FSU) at \$43.711bn, and imports at \$32.959bn; these represent, respectively, 25.3% and 19.1% of GDP.⁷ Such figures suggest a much greater dependence upon foreign trade than the EU countries.

What does seem clear is that the share of foreign trade with the EU has increased in importance throughout the early 1990s. The FSU's total exports of merchandise to the Community amounted to \$19.7bn in 1990 (excluding Eastern Germany), increasing by 9.6% to \$21.6bn in 1991 (although this figure included the Eastern territories), by 1.9% to \$22bn in 1992,⁸ by 2.3% to \$22.5bn in 1993,⁹ and by a massive 36.9% to \$30.8bn in 1994. FSU imports from the EU also increased over this period, from \$16.9bn to \$23.4bn, in other words by 38.9%.¹⁰ These increases compare very favourably to decreases in real GDP in 1991 of 11.6%, in 1992 of 18.2%,¹¹ in 1993 of 12.0%, and estimated in 1994 at 15.0%.¹² Not only does this growth in trade with the Twelve contrast sharply with the

because using an average exchange rate for a period which saw a 199% appreciation of the dollar (in relation to the ruble) would only be a close approximation if the foreign trade was very evenly spread throughout the year, whilst in fact it appears that over 36% of exports were traded in the last quarter of 1993 (figures from the Market Research Centre under the Russian Government, in *Segodnia*, 13 April 1994, and from *Ekonomicheskaja gazeta*, no. 16, April 1994). Finally, although Russian prices in 1993 were much closer to world prices than they had been for seventy years, there were still large variations; in September, for example, the commodity exchange price of crude oil in Russia was 28% of 'world' price, petrol 58%, aluminium 65%, and wheat 54%, although sugar was overvalued at 152% (from Martin McCauley, 'The Russian Economy — January/September 1993', *Russia and the Successor States Briefing Service*, vol. 2, no. 3, June 1994).

⁷ If the latter is taken to be Rb162,300bn, and is converted at the average exchange rate for 1993 of Rb941:\$1. Export and import figures taken from 'Bankovskii biulleten', *Ekonomicheskaja gazeta*, no. 16, April 1994; GDP figure from EIU, *Country Report — Russia*, 2nd quarter 1994, p. 4; average exchange rate calculated by getting the average of two weekly readings from the MICE for every week of 1993. My estimate of the average exchange rate is slightly lower than that of the EIU (Rb985:\$1), the latter probably being overestimated by having used every reading from the MICE, which would give a disproportionate weighting to the higher dollar rate of the second half of the year, as MICE started dealing daily from June 1993.

⁸ OECD, *Short-Term Economic Indicators: Transition Economies*, Paris, 1994, p. 25.

⁹ 'Russia and European Union Reach Historic Agreement to Deepen Trade and Political Ties', European Commission Document IP/94/565, 22 June 1994, p. 5; the figure for FSU exports to the EU in 1993 is 18.5bnECU, converted here at a mid-1994 rate; the same figure for Russia exclusively is 14.8bnECU.

¹⁰ *Towards Greater Economic Integration — The European Union's Financial Assistance and Trade Policy for Central and Eastern Europe and the New Independent States*, European Commission, DG 1A, Brussels, October 1995, p. 15 — here also, the same mid-1994 Ecu:Dollar rate is used as above.

¹¹ IMF, *World Economic Outlook*, Washington DC, May 1994; the figures are weighted averages of the separate estimates for the various FSU states, mostly referring to net material product.

¹² According to EIU figures in EIU, *Country Report — Russia*, 2nd quarter 1995, p. 4.

collapse in the ex-CMEA's proportion of Russia's foreign trade, from 50% in 1990 to 28.1% in 1991¹³ and 20% in 1992;¹⁴ it also generally compares favourably to the increase in total hard currency exports by 9.0% to \$53.2bn in 1991, their decrease by 22.7% to \$41.1bn in 1992,¹⁵ falling behind the 11.3% increase in these exports in 1993, to again outdo the 11.4% increase (to \$51.6bn) of 1994.¹⁶ The proportion of official hard currency exports which were destined for the Community thus rose from 40.4% in 1990 (excluding the ex-GDR), 40.7% in 1991 (including the ex-GDR), and of 53.4% in 1992. Of all Russia's trade partners, the EU is undeniably the most important in volume.

At least as important as the monetary value of Russian foreign trade is its strategic significance. It is arguable that, as the economy of the FSU is potentially one of the world's most self-sufficient economies, there is no great need for the CIS to prioritize large-scale foreign trade. This was seen as a main reason for the USSR not joining the IMF and the IBRD at their inception, despite the Soviet delegation attending the UN Monetary and Financial Conference in Bretton Woods in 1944, and even signing the draft agreement to the setting-up of these institutions, but later renouncing membership when their conditions were not met.

The dream of independence from capitalist imports was not to last very long, however. By the 1970s, despite the small size of Soviet foreign trade, the USSR was already very dependent upon imported capital. A large proportion of the imported commodities were essential to alleviate bottlenecks in industry, which were particularly damaging in the highly interdependent Soviet economy. The importance of Western equipment as a short-term solution to a bottleneck rather than a well-planned strategy was suggested by the fact that so many pieces of equipment were bought, rather than the licence to produce them, despite the

¹³ According to Goskomstat figures, converted into dollars, *Russian Economic Trends*, vol. 1, 1992, no. 1, pp. 48-49.

¹⁴ According to EIU figures in EIU, *Country Report — Russia*, 2nd quarter 1994, p. 4.

¹⁵ Ibid.

¹⁶ According to EIU figures in EIU, *Country Report — Russia*, 2nd quarter 1995, p. 4.

latter option being much cheaper and more sustainable in the long term.¹⁷ Whether as immediate solutions to shortcomings in production or long-term aims of technology transfer, the share of foreign materials used in production kept increasing, until in 1986 the food industry was importing 46.8% of its machinery, and the chemical industry 49.9%, whilst Western equipment also accounted for between 66% and 100% of Soviet polythene, 65% of all complex fertilizers and 40% of all nitrogenous fertilizers.¹⁸ By 1989, the proportion of equipment for the chemical industry which was imported had risen to 61.4%.¹⁹ Although foodstuffs have also been a very important component of imports, still accounting in 1984 for a greater share of imported goods from non-socialist countries (29.7%, according to Vneshtorg figures in rubles) than machinery and equipment (22.4%²⁰), by 1993 machinery and equipment were the most important sector of imports, accounting for 38.5% (in more reliable hard currency figures for the period from January to September), compared to 28.5% for foodstuffs and agricultural produce.²¹ Thus despite its size and great natural wealth, by the mid-1980s the USSR had a high level of dependence on imports from Western countries, and this dependence has only increased since the demise of the Soviet Union.

A new approach to foreign trade finally materialized under Gorbachev. Although the oil price rises in the 1970s made it particularly easy for the Soviets to count solely on their energy exports for their foreign currency, exports were still considered to be a last resort, a necessary evil; Soviet products would be sold abroad purely in order to pay for essential imports, not because exports were desirable *per se*. Despite earlier moves by Gorbachev to transform the Soviet trade deficit into a surplus, with *perestroika* came a new positive attitude towards foreign trade, not least because Gorbachev did not have the luxury of the 1970s

¹⁷ Alan Smith, 1993, op. cit., p. 60.

¹⁸ Leonard Geron, op. cit., p. 29.

¹⁹ Alan Smith, 1993, op. cit., p. 63.

²⁰ Ibid., p. 56.

²¹ *Segodnia*, 13 April 1994; it should be noted that the figure for foodstuffs may have been disproportionately low due to the fact that food imports are often highest in the last quarter.

oil price booms. Quite apart from the fall in oil prices, terms of trade during the twelfth Five-Year Plan (1986-90) also worsened for the USSR because of the weakening of the American dollar against European currencies. This was detrimental because although the USSR sells its oil in dollar terms, most of its equipment purchases are in European currencies (some 70% of Soviet convertible currency purchases are made in currencies other than the dollar).²²

Opening up foreign trade, eventually, to all enterprises was just one of Gorbachev's moves to reform the Soviet economy, the expression of a movement which had started in the early 1980s.²³ The problems to be tackled were enormous. The Soviet Union's net debt²⁴ was already \$9.5bn in 1984, \$26bn by 1987, and \$84bn by the time the CIS was presented with the contentious task of dividing it amongst the republics in late 1991.²⁵ Although this was not a disastrous figure in relation to the size of the CIS's economy, and particularly not for Russia, which, for example, had a \$9.1bn trade surplus in 1991,²⁶ it was still a bad footing from which to increase foreign trade. One policy deeply regretted in Moscow has been the provision of credit to many Third World countries (mostly to buy arms; the USSR accounted for around 39% of the Third World arms market in 1989), which by 1982 had cost the USSR approximately \$50bn.²⁷ The FSU's estimated \$90.8bn external debt in 1993²⁸ was a major reason for the reluctance of Western investors or exporters to risk capital in the CIS, second only to political instability.

²² Leonard Geron, op. cit., p. 29.

²³ Many experts see Tatiana Zaslavskaja's 'secret paper' as a milestone. It was delivered in April 1983 (shortly after Andropov replaced Brezhnev), and claimed that the central planning system could no longer cope and that more autonomy should be given to enterprises.

²⁴ Net debt = debts to BIS area banks + other hard currency debt (mainly to official creditors) — bank deposits with BIS area banks. Figures from Michael Ellman, *The USSR in the 1990's*, EIU Special Report no. 1152, London, 1989, p. 73.

²⁵ *The Guardian*, 14 January 1992; this figure was used at a meeting in Germany, concerned with the sharing of the CIS debt. Estimates of the debt in late 1991 and early 1992 fluctuate between \$57bn and \$84bn (*The Economist Intelligence Unit Country Report on the CIS*, no. 1, 1992, p. 68).

²⁶ *Ibid.*, p. 67.

²⁷ Michael Ellman, 1989, op. cit., p. 72.

²⁸ IMF estimate in IMF, op. cit., 1994, p. 163; the IMF's estimate for the USSR's external debt in 1991 was \$67.1bn.

Thus, although it is impossible to accurately calculate the proportion of foreign trade in relation to Russian GDP, it is clear that importance of exports and imports to Russia is greater than the monetary value might suggest. Traditionally, the goods bought with the foreign currency earned by Russia are in large proportion strategic goods, in the sense that without them production would significantly decrease (even further than may already be the case). This is particularly the case with the restructuring of Russian industry, as modern technology is needed to reorientate production towards the more modern and complex goods demanded by today's markets. The need for increasingly advanced technology explains why trade with the EU continues to increase even in its monetary importance, at a higher rate than overall foreign trade, and despite the sharp decreases in production, both overall and more specifically in oil and gas, still Russia's main export commodities. This dependence on Western strategic goods is now complemented by a growing demand for foreign consumer goods and foodstuffs, which is both cause and effect of a failure on the side of private electronics producers and farmers to take over from large and often obsolete Soviet factories and collective farms. Russia would be in a very severe state of crisis if its imports were ever strongly curtailed.

3.3 Traditional Weaknesses of the Soviet Economy

Russia's inability to become a powerful and versatile participant in world trade is inextricably linked to its domestic economic problems. The scope of these problems is virtually unlimited and this thesis can only superficially deal with them, although this type of summary is nonetheless helpful in understanding the organizational and psychological barriers which new entrepreneurs must tackle in order to succeed in foreign trade or in translating foreign investment into profit, and in estimating the possible role of the EU.

During his leadership, Gorbachev had only limited success in reforming a centralized planning system which had in essence changed very little since Stalin had ensured the Kremlin's firm control over every important aspect of the economy. Tendencies to over-staff (in order to secure additional capacity, in the event of a sudden increase in plan quota), to overstate needs (as one always received less than one ordered) and to understate capacity (as whatever capacity was declared would have to be increased the following year, according to the 'ratchet principle'), are amongst the most damaging habits acquired under Soviet Communism. Wherever possible, the actual figures of output would also be tampered with, if needed to fulfil the all-important plan. Thus the whole economy was based on largely false data.

Regardless of the accuracy of the data, the task of using it to calculate the supply and demand for every important commodity in the economy was impossible. The central planning authorities used a system of material balances, whereby each product's demand (as ordered by every enterprise) would be matched to possible sources of supply. Until the late 1980s, Gosplan worked out the material balances for 2,000 commodities, whilst Gossnab (the State Supply Committee) handled approximately 20,000 commodity groups.²⁹ This task in itself was unmanageable enough, but then came the constant need to re-adjust the figures, a task made particularly complex by the fact that many goods are interdependent; for example, when changing the material balance for steel, the balances for coal, iron ore, train carriages, and therefore for steel itself, would all have to be re-adjusted. In fact and practice, however, because of the complexity of performing multiple iterations of what is in fact a 20,000 x 20,000 matrix, relationships of the second order, to say nothing of those of third or fourth order, were only made when volumes involved were substantial.³⁰ A high degree of inaccuracy, therefore, was inevitable.

²⁹ Alan Smith, 1993, op. cit., p. 37.

³⁰ David A. Dyker, *Restructuring the Soviet Economy*, London, 1992(i), p. 9.

The main success indicator in Soviet industry until Gorbachev's reforms was still volume, despite attempts to change this in the mid-1960s. Other factors had been measured, but there was little or no impact on bonuses for good results, for example in being more cost-effective. It is therefore easy to understand the shoddiness of many Soviet goods; the combination of fixed-time plan quotas and virtually no quality control was especially disastrous, explaining practices such as television manufacturers using hammers to drive in screws to fulfil the plan before the month is out (Soviet consumers often tried to avoid buying goods manufactured at the end of the month). This is one problem which *perestroika* had started solving, as profit became vital for the survival of an increasing number of enterprises, under the policy of *khozraschet* (self-accounting) and *samofinansirovanie* (self-financing). Old habits die hard, however, and many enterprises have been unable to become profitable. The fact that plant closures and mass redundancies were not resorted to helped to protect old working methods, as did the continued granting of credits.

Gorbachev's attempts at agricultural reform were yet less effective. State farms and collective farms were allowed to continue operating, and although private farmers were in theory able to rent and cultivate their own land, keeping all profits, in practice little was done to prevent local collective farm managers and party cadres from obstructing the *arenda* (land-renting) programme. Thus a country with vast areas of rich soil had to go on spending an important share of its foreign currency on importing wheat (in 1986, \$1.6bn was spent on OECD wheat, 7.8% of all imports from OECD countries³¹). The lack of livestock fodder was an important contributing factor to the inability to meet the demand for meat, meat production in 1982 having slumped to 6% below the 1975 level; this is yet another example of centrally set prices not reflecting the true cost of production, which in the case of meat should have been particularly prohibitive when the use of large amounts of Soviet grain for fodder led to the necessity of turning to imports. The inadequacies of the Soviet transport system were at their most

³¹ Michael Ellman, 1989, op. cit., p. 14.

damaging in the failure to get a high percentage of agricultural goods to the market-place before they rotted.

The Soviet economic system had traditionally been heavily biased against innovation. As there had been no freedom to enter markets where a supernormal profit could be made, there was no incentive to broaden the range of commodities produced; even within existing production, any extra efficiency would cease to generate supernormal profits from the following year, when the 'ratchet principle' would simply add to the present year's output to determine the new quota. The lack of competition, or of 'creative destruction', meant that there has been no need to innovate to stay in business; on the contrary, by trying new methods a manager would simply risk losing his bonuses by failing to fulfil the plan. Even enterprises whose function it is to do research and development have had their success measured according to *volume* of output! Despite the gradual emergence of profit as the main aim of production, Russian inventors and researchers have much time to make up for.

These failings of the domestic economy are intrinsically linked with the needs and problems of foreign trade. The low levels of output and of quality fail to satisfy all the domestic needs, leaving few fields with exportable surpluses, and creating a need to spend scarce hard currency on imports.

3.4 Gorbachev's Attempts to Liberalize Foreign Trade

As early as 1977 the Soviet government started making moves towards freer foreign trade — in that year ministries and departments were granted the right to exchange goods directly (or through Vneshpromtekhnobmen) with parallel institutions in CMEA countries. Then in May 1983, Andropov legalized the establishment of joint ventures with CMEA countries (on USSR territory); in practice the procedure was overly bureaucratic and rigid, however, and was not implemented. Another measure which achieved limited success was taken in June

1984, when Chernenko's leadership laid down procedures for direct production, scientific and technological cooperation between ministries, departments and associations in CMEA countries and Yugoslavia; industrial enterprises also gained the right to set up their own funds for the development of international cooperation.

Gorbachev's own measures to liberalize trade first appeared in August 1986, when two important resolutions were passed; one 'On Measures to Improve the Management of Foreign Economic Relations', and the other 'On Measures to Improve the Management of Economic, Scientific and Technical Cooperation with Socialist Countries'. The former resolution stated that ninety-seven ministries, departments and enterprises would now be granted the right of direct transaction with foreign enterprises,³² whilst previously all foreign trade was conducted by less than sixty state-controlled foreign trade organizations (FTOs).³³ The second resolution concerned the setting-up of joint ventures (JVs) with socialist countries, and ensured that Gosplan would no longer determine import and export levels for individual associations, enterprises and organizations; these bodies could also now use the foreign currency they earned (after high taxes) for their own purposes.³⁴

The next set of trade-freeing policies came in January 1987, with decrees setting out legal regulations for joint ventures, both with CMEA countries and with non-socialist countries. Joint ventures could develop and approve their business operation programmes without interference from Gosplan or the central authorities. Any equipment or other property imported to the USSR by the Western side of the venture would not be charged import duties. A two year tax exemption was also specified, and there were a multitude of positive general statements about JVs.³⁵ A profit tax of 30% (basic rate) and a profit repatriation tax of 20% (basic rate) were at first applicable to JVs.³⁶ As the months went by,

³² Leonard Geron, *op. cit.*, p. 101.

³³ Alan Smith, 1993, *op. cit.*, p. 42.

³⁴ Leonard Geron, *op. cit.*, p. 101.

³⁵ *Ibid.*, p. 24.

³⁶ David A. Dyker, 1992(i), *op. cit.*, p. 91.

however, very little of the expected enthusiasm (and hard currency!) materialized, hence the 'Decision on Improvements' which was issued in September; it extended the two year tax exemption, now to be counted from the date of first profits, and there was also a simplification of the procedures for setting up joint ventures.³⁷

A new level of trade opportunity for Westerners was achieved in December 1988, with the decision 'On further Development of the Economic Activity of the State, Cooperative and Other Public Enterprises, Associations and Organizations', whereby a foreign partner could hold a majority share in a JV, and there would no longer be any restriction on remuneration of employees. A foreigner was now allowed to become chairman or managing director of a JV, and foreign partners could now pay for the accommodation of foreign workers in rubles. Another stimulus for foreign investment was a reduction of JV profit taxes (from 30% to 10%), a longer tax holiday (from 2 to 3 years) in the Far East, and repatriation taxation could be waived altogether for foreign partners.³⁸ More and more milestones were reached in the autumn of 1990, when full foreign ownership of JVs was allowed.

Cooperatives also received encouragement, when in April 1989 they were granted the right to deal directly with foreign enterprises. They could keep a 'considerable proportion' of their currency income, and spend up to 10% of it on consumer goods, medical goods, improving the workplace, and similar expenditure.³⁹ By April 1990, 2,500 cooperatives had been registered as participants in foreign trade.⁴⁰ The April 1989 Decree not only permitted cooperatives to deal in foreign trade, but granted this right to all associations and enterprises, subject to the procurement of a licence from the Ministry of Foreign Economic Relations (after the merger on 1 January 1988 of the Ministry of Foreign Trade and the GKES).⁴¹

³⁷ Leonard Geron, *op. cit.*, p. 24.

³⁸ *Ibid.*; and Michael Ellman, 1989, *op. cit.*, p. 95.

³⁹ Abel Aganbegyan, *Moving the Mountain*, London, 1989, pp. 184-85.

⁴⁰ Leonard Geron, *op. cit.*, p. 26.

⁴¹ Alan Smith, 1993, *op. cit.*, pp. 131-32.

The joint venture legislation, especially the later measures to seduce Western businessmen into investing in the Soviet Union, eventually had a positive effect. 'There is a clear correlation between the loosening of legal restrictions and the number of JVs registered', wrote Geron, pointing out that the number of JVs increased from twenty-three in 1987 to 191 by the end of 1988, and to over 1,600 by June 1990.⁴²

Despite the regressive steps taken in the previous year (described below), March 1990 saw the passing of the 'Law on Property in the USSR' which allowed foreign individuals, as well as foreign companies, to be participants in JVs; it also catered for JVs to be set up as joint stock companies, partnerships with or without limited liabilities. Foreign juridical bodies were permitted to own industrial or other property, although excluding land, for the purpose of their business. Then in June the law 'On Taxes on Enterprises, Corporations and Organizations' (corporate tax law), was passed, which was to establish a unified rate of tax of 45%, but with JVs to be taxed on a differentiated basis according to the size of foreign share: JVs with less than 30% of foreign share were to pay full Soviet tax, whilst JVs with more than 30% paid only 30% tax,⁴³ although this could vary according to particular circumstances. There was now a clear advantage, on the Western side of a venture, to become more deeply involved.

Although these efforts never achieved the high level of foreign investment for which the Soviet authorities had hoped, it nonetheless steadily increased. The spirit of these liberalizing measures greatly augmented Western businessmen's interest and desire to deal with the USSR, and Russia in particular. The number of JVs in Russia, by the end of 1991, exceeded 2,600 and involved over sixty countries, employing some 130,000 people, with a yearly turnover of more than Rb11bn, over 3.5 times that of 1990.⁴⁴

⁴² Leonard Geron, op. cit., pp. 43-44.

⁴³ Ibid., p. 102.

⁴⁴ Radio Moscow World Service in English, 8 February 1992, from *Summary of World Broadcasts (SWB)*, Weekly Economic Report, Former Soviet Union, 14 February 1992.

Another approach designed to lure foreign investment which attracted much attention during this period was the establishment of Special Economic Zones (SEZs) and Free Economic Zones (FEZs).⁴⁵ The first official statement by Gorbachev announcing the intention to establish special zones for joint entrepreneurship came in September 1988, and even these early measured moves towards granting advantageous investment conditions for FEZs suggested much potential for local authorities and enterprise managers to encourage autonomous border trade, control regional foreign exchange reserves, and establish direct transactions at grassroots level with foreign businesses. FEZs were also seen as a way to entice JVs away from Moscow, which in early 1990 was home to 45% of Soviet joint enterprises. The fact that FEZs could be used as a tool to gain support from regional authorities in exchange for promises of increased self-determination was not lost on the RSFSR authorities; between May 1990 and June 1991, the Russian Supreme Soviet granted FEZ status to eleven territories. The types of benefits which were offered by some of these FEZs included profit tax rate as low as 10% (compared to 25-30% basic rate in 1991, and 32% in 1992), up to five years' tax holiday, restriction-free barter transactions in foreign trade, and duty free and tax-free imports and exports.⁴⁶

One of the greatest problems faced by anyone trying to do business outside the official plan was always that of finding supplies, as a free wholesale-trade market was nonexistent. In this field also, *perestroika* established the first structures which would allow freedom of choice of supplier. In May 1990, a commodity exchange was set up in Donetsk, and, at the beginning of June 1990, another was set up in Moscow.⁴⁷ By the autumn of 1991, there were commodity exchanges, as well as stock exchanges, in most large cities of the USSR, dealing

⁴⁵ It is often difficult to distinguish between the two, but Geron's rule of thumb is that the 'FEZ is seen to differ from SEZs in so far as it emphasises changes to the local economy as a whole, not just means of encouraging foreign investment'; Leonard Geron, op. cit., p. 51.

⁴⁶ Sergei Manezhev, 'Free Economic Zones in the Context of Economic Changes in Russia', in *Europe-Asia Studies*, vol. 45, 1993, no. 4, pp. 610-13; these territories were: Vyborg, Primorskii krai (including Nakhodka), St Petersburg, Kaliningrad oblast', Chita oblast', Altai krai, Kemerovo oblast', Novgorod oblast', the Jewish autonomous oblast', Sakhalin oblast' and Zelenograd.

⁴⁷ Leonard Geron, op. cit., p. 49, taken from *Izvestia*, 19 May 1990, and *SWB*, SU/0782i, 5 June 1990.

in just about anything, from foodstuffs and building materials, to motorcars, metals and oil.

Gorbachev had also taken the first steps along the road to convertibility, starting with the devaluation of the ruble's tourist rate, first to Rb10:£1, and then to almost Rb50:£1 in April 1991. The move to total hard currency dealings in CMEA trade was another clear sign that the USSR was determined to have an ever more convertible currency. Currency auctions, starting in the autumn of 1989, slowly became more efficient, with a growing number of traders being allowed, and small but increasing volumes of currency changing hands.

Gorbachev's privatization drive had also met with some success; by March 1991, Moscow City Council's Committee for Privatization had identified 16,000 businesses which could be sold off; already, some thirty-two tailoring workshops and fifteen hairdressing salons had been privatized, 'mainly by transfer of control to employees'.⁴⁸ One sector of privatization in which there was particular hope was agriculture. Families or small groups have had the legal basis for using patches of *kolkhoz* or *sovkhos* land for farming ever since the 1988 'Law on Cooperatives', and although the uptake was very slow, the Russian Goskomstat reported that by the middle of 1991, there were 20,000 individual farming units.⁴⁹ Foreigners' involvement in privatization, however, was not at that stage possible.

Thus from the point of view of a potential West European exporter or investor, Gorbachev's foreign trade reforms had achieved a great deal. Most important of all was the fact that the state's monopoly on foreign trade had been broken; although accreditation processes, obtaining licences and paying tariffs were all significantly restrictive, there was nonetheless a real possibility to establish partnerships with foreign businesses, and/or to earn foreign currency from exports. The joint venture initiative was a hand outstretched to the developed world for cooperation and development, and it generated much enthusiastic, if not fearless, response. Yet although the ideas and the direction

⁴⁸ Alex Brummer, 'Pulled From the Ruble', *The Guardian*, 22 March 1991.

⁴⁹ TASS World Service in English, 24 January 1992, from *SWB*, Weekly Economic Report, Former Soviet Union, 31 January 1992.

were commendable, in practice Gorbachev's policies had many failings, as shown by the disappointing output and trade figures. These are examined in the following section.

3.5 Barriers to Reform Facing El'tsin

Despite its positive approach and worldwide acclaim, *perestroika*, in the short term, had been damaging to the Soviet economy. When El'tsin became the most powerful man in Russia, following the failed August *coup*, he inherited an economy which was in a state of accelerated decline. By the first quarter of 1991, Soviet output was 12% less than the year before,⁵⁰ and GDP was to be down almost 13% by the end of that year.⁵¹

Although a great deal of positive legislation had been passed by Gorbachev, the degree of execution had been disappointing. The level of involvement in joint ventures, for example, was still not very encouraging. Although the number of discussed projects had been fairly respectable, only a small percentage of these ventures were actually being set up, and the average capital of those that did take off was relatively low (approximately Rb1m). Another factor discouraging Western involvement in JVs had been the confusion which seems to prevail in the implementation of joint venture legislation. One good example was the corporate tax rate for JVs, which according to the decree of January 1987 should normally have been 30% on the net profit and another 20% on profits repatriated abroad (in other words a maximum tax rate of 44%, if all the remaining 70% are repatriated), but which was negotiable in every case.⁵² This was a scenario, like so many others, which openly invited corruption. As discussed below, however, the fiscal position of JVs has since altered again.

⁵⁰ John Pinder, 1991, op. cit., p. 57, taken from *The Financial Times*, 11 March 1991 and 10 April 1991.

⁵¹ EIU, *Country Report — Russia*, 2nd quarter, 1995, p. 4.

⁵² Leonard Geron, op. cit., p. 45.

El'tsin was left with a desperate need to clarify the jurisdiction of the different levels of government, especially with respect to their taxing authority and expenditure responsibility, if an effective and realistic fiscal policy was to be devised. Under Gorbachev's 'guidelines', all that had been specified was that both the Union and the republics could levy taxes, but federal tax rates and liability to federal tax had to be approved by the republics.⁵³ This resulted not only in confusion in tax collection, but also in the encouragement of tax evasion.

There had also been actively regressive legislative moves against freer foreign trade in the last years of Gorbachev's leadership, such as the strict decision passed in December 1989, greatly increasing the number of goods which needed an export licence, to include most foodstuffs, vodka, most fibres and clothes, electrical appliances, and many more. This same decree of the Council of Ministers outlawed the export of foodstuffs, fossil fuels, construction materials and others through barter operations.⁵⁴ An additional problem was that most of the licences were issued by the Ministry for Foreign Economic Relations, which itself dealt on foreign markets, and was inevitably biased in its decision-making.⁵⁵ Much hard currency revenue from exports was thus lost.

El'tsin took power at a time when lack of confidence in Russia's political stability, and in the impartiality of the judiciary, was great. Even at the peak of *perestroika* such apprehension was shown not to be unfounded; for example when a diplomatic row erupted in mid-1989 over spying charges against Soviet personnel in London, and the Soviet Union was only at the last moment persuaded not to limit the numbers of foreign businessmen in Moscow as one of their 'tit-for-tat' measures. Fear of a renewed Cold War, resulting in tighter trade restrictions being reimposed, had never fully dissipated. As civil war erupted in some areas of the former Soviet Union, and the political situation in Russia remained unstable, worries about the security of potential investments became greater than ever.

⁵³ EEC report on the Soviet economy, p. 93.

⁵⁴ Leonard Geron, *op. cit.*, p. 105.

⁵⁵ *Ibid.*, p. 25.

Western banks remained extremely reluctant to risk new funds in Russia, unless they were fully collateralized. Although banks in the West are not averse to occasional high-risk investments, the high level of uncertainty and poor quality of financial information in Russia go beyond what most investors perceive as viable risk.⁵⁶ In contrast to the period up to 1990, when the USSR's creditworthiness was impeccable, payments have since gone deeply into arrears. Of the estimated \$65.1bn (Vneshekonombank figure; see footnote 24 in section [ii] of this chapter) owed by the former USSR,⁵⁷ around \$20bn was due in 1991, most of which had to be deferred. In losing its high credit rating, El'tsin's Russia had lost one of the few relative advantages it had over its neighbours in Eastern Europe, from West European investors' point of view.

Another area in which the West had little confidence at the end of 1991 was that of convertibility of the ruble. Even the ruble's commodity convertibility, that is the extent to which the ruble could be translated into desired goods or services, was minimal by the time of the *coup*. Although Gorbachev had devalued the ruble, and introduced the concept of hard currency auctions, these auctions were irregularly held, had very restricted access, and had only a limited amount of hard currency to offer, put forward by the RCB. The result was a very biased exchange rate, only achieved for relatively small amounts of currency by privileged enterprises and organizations. This situation could at best be defined as extremely limited internal convertibility.

If there was to be any chance of a greater degree of convertibility being achieved with any measure of stability, the Soviet approach to monetary control had to change radically; yet despite expressing this aim, the pre-*putsch* leadership failed to sufficiently tighten the money supply. Although Gorbachev's government had managed to reduce the budget deficit to a 'mere' Rb58.1bn in

⁵⁶ See Volker Burghagen (Head of the International Division of the Dresdner Bank), 'Soviet Financial Policies Towards the West', *The Soviet Economy under Gorbachev, NATO Colloquium*, 20-22 March 1991, Brussels, Brussels, 1991, pp. 183-87.

⁵⁷ Vneshekonombank figure, given by TASS World Service in English, 19 January 1992, from *SWB*, Weekly Economic Report, Former Soviet Union, 24 January 1992.

1990, less than half of what it was in the previous year,⁵⁸ the slowing down of reform momentum was accompanied by a renewed slackening of credit in 1991. By the end of that year, the USSR's budgetary deficit was Rb205.7bn, of which Rb108.4bn was Russia's (despite Russia's budgetary income having increased by around 60% to Rb291.7bn, according to Goskomstat). This brought total internal debt to Rb990bn for the USSR, and Rb572bn for Russia.⁵⁹ The increase in money printing was not compensated for with inflation, therefore the monetary overhang kept growing. In 1991, people's income exceeded expenditures by Rb87.1bn, compared with Rb19.2bn in 1990; by the end of December 1991 the population had Rb161.9bn in ready cash, according to TASS.⁶⁰ This mass of liquid assets inevitably created an inflationary pressure which made price liberalization even more difficult.

It was on freeing prices that Gorbachev's 'Basic guidelines for the stabilization of the national economy and the transition to a market economy', the compromise synthesis of the 'Shatalin Plan' and the 'governmental' (mostly Prime Minister Ryzhkov's) proposals, was at its least ambitious in relation to the Shatalin plan (the '500 days' project). At producer and wholesale level, distortions in relative prices were to have been administratively reduced, and although 49% of producer prices were to be negotiable between enterprises, they were still subject to the surveillance of the central authorities; in retail prices, some 15% of prices (mainly for 'luxury goods') were to have been freed by the end of 1990, and further price liberalization was to depend upon the extent of macroeconomic stabilization being achieved. It was hoped by advocates of greater decentralization of the economy that in 1991 responsibility for consumer subsidies, and hence, eventually, for the prices, would go to republican authorities.⁶¹ The Gorbachev 'solution' was not only much less ambitious than Shatalin's, it was even more superficial than Ryzhkov's proposals; the still widely

⁵⁸ *The Guardian*, 15 February 1991.

⁵⁹ *The Economist Intelligence Unit Country Report on the CIS*, no. 1, 1992, op. cit., p. 53.

⁶⁰ TASS World Service in Russian, 24 January 1992, from SWB, Weekly Economic Report, Part 1, Former Soviet Union, 31 January 1992.

⁶¹ *Ibid.*, p. 12.

centralized Soviet economy needed a much stronger and clearer blueprint of what to do next. In fact, any optimism about freeing prices soon faded with the measures taken by Valentin Pavlov (who had replaced Ryzhkov as Soviet Prime Minister), which increased prices, but through central control, thus continuing to hide the signals of supply and demand from producers, whilst nonetheless fuelling popular anger at the resulting inflation.

In areas less directly related to foreign trade, the gap between theoretical and practical reform had been even greater. With regard to the attempts to free the supply side, despite the 'Law on State Enterprises', in 1988-89 most of the industrial output still went through the system of state orders, and the role of Gosstab as the organizer of suppliers and clients for large enterprises remained basically unchanged.⁶² With the collapse of the Soviet Union, as attempts were made to gradually abolish the *goszakaz* (state order) system, a great many enterprises became threatened with (theoretical) bankruptcy as they failed to find suppliers or buyers; trade between the republics plummeted, as new customs had to be faced, and confidence in the ruble collapsed, leaving only bartering as an option. On the individual consumer's level, the long-existent need to obtain commodities from friends and contacts became increasingly unavoidable. An ever-greater proportion of Russian consumer goods production was misappropriated before making it to the shelves of retail outlets, with corruption and mafia involvement mushrooming as the general level of discipline and authority declined. The result was that in 1991, there was a centrally imposed return to traditional supply links, and continued extensive usage of state orders. These measures failed to halt the fall in production and trade, but they did succeed in reversing the positive momentum in the supply side reforms.

The much-lauded privatization process had achieved virtually no concrete results by the end of 1991. Privatization's first result was to trigger stubborn resistance amongst large enterprise and collective farm managers, who refused to allow their power to be dissolved so easily. Even if the bureaucratic wrangles

⁶² IMF, 1994, op. cit., p. 4.

could be solved, the original intention of absorbing a large proportion of the inflationary overhang through the sales of shares was never likely to succeed. The public was highly aware that a high percentage of the enterprises being sold to the public were likely to go bankrupt once they became self-financing.⁶³ For privatization to be effective as a macroeconomic stabilizer, there was also a need to increase public confidence in government schemes in general. The improbability of this should have been learnt in 1990, when a governmental scheme to finance part of the budget deficit through sales of 4% government obligations was largely unsuccessful.⁶⁴ The government was never perceived as a good investment in the Soviet Union.

By 1992 even pro-shock therapy economist Jeffrey Sachs had recognized that privatization of large-scale enterprises could not be carried out quickly, and that therefore other measures, such as macrostabilization and price liberalization had to occur first, without being able to use mass privatization of large enterprises as an effective tool to absorb the monetary overhang.⁶⁵ Nonetheless, privatization had to remain a priority, starting with small and medium-size enterprises; this was essential if the Russian economy was to be seen by the EU and other countries as a viable target for investment. It was needed to increase business confidence in Russia, but had another important function — Anders Åslund suggested that ‘it matters less who owns shares than that there is an active assessment of the values of various forms of capital by many mutually independent traders’.⁶⁶

Linked to the problem of privatization was the need for a fully functional banking system, which would permit the use of interest rates as an effective macroeconomic lever. The introduction of reserve requirements, refinancing policies and the lifting up of real interest rates at least to a non-negative level were still desperately missing. By December 1991, even the commercial banks

⁶³ Edgar L. Feige, ‘Perestroika and Socialist Privatization: What is to be done? And how?’, *Comparative Economic Studies*, vol. 13, no. 3, 1990, pp. 1-54.

⁶⁴ IMF, 1994, op. cit., p. 9.

⁶⁵ Alan Smith, 1993, op. cit., p. 196; although macrostabilization has not in fact been fully achieved, whilst privatization is at an advanced stage, the point is that privatization could not be used to cushion the hyperinflation resulting from price liberalization.

⁶⁶ Anders Åslund, *Gorbachev's Struggle for Economic Reform*, London, 1989, p. 188.

were lending money at an average of 20.4% p.a.,⁶⁷ whilst the average annual rate of Russian inflation for 1991 was 92.7%,⁶⁸ and rising fast.

For trust in banks to increase, not only did the interest rates have to become higher than inflation, but confidence in money itself had to be restored. The extraordinary move of banning all 50 and 100 ruble notes from circulation in the spring of 1991, although moderately helping to reduce the inflationary overhang, showed a total disregard for the need to increase the respect for money in the Soviet economy. Although citizens had a few days to exchange their 50 and 100 ruble notes, this move set a precedent which, it was feared, could be repeated for some or all of the other notes in circulation. Thus the traditional feeling that holding rubles did not necessarily mean the possibility of acquiring goods, and the tendency to exchange rubles for commodities at the earliest opportunity, were both reinforced by this measure.

The confidence in the government itself, which in the early days of *perestroika* had risen considerably, had been severely undermined by the time of the August *coup*. This was due in part to Gorbachev's lack of legitimacy, as he had not been popularly elected. In contrast, El'tsin's electoral mandate gave him a clear advantage. Gorbachev's unpopularity, however, ran much deeper. Mikhail Sergeevich had brought the government down to pre-*perestroika* depths in the eyes of the population; yet again, fantastic promises had been made, only to be broken, then changed, and unfulfilled again. The names of the goals had changed, but they remained utopian slogans nonetheless. Despite his success and popularity abroad, Gorbachev became unpopular at home most of all because he allowed prices to rise, whilst shops remained empty. Gorbachev's attempts to make the Soviet economy more compatible with that of the EC had left many with no cause to rejoice.

⁶⁷ *Russian Economic Trends*, vol. 1, no. 1, 1992, p. 16.

⁶⁸ IMF, 1994, op. cit., p. 126.

Much criticism followed from all sides, but most harshly from the neo-Slavophiles. One of the vocal figures of this opposition was the author Mikhail Antonov, who wrote that

people are already signing agreements on 'free economic zones'. This insults me personally, as a Russian and as a Soviet citizen, it affronts my patriotic feelings [...] We are not an underdeveloped country, we are a great industrial power, and if we remove the interfering administrative and economic cobwebs from the people [...] then in a short time they will be able to flood the market with food-products and to create any super-modern technology without foreign mentors and culture-bearers.⁶⁹

An article by Andrei Kuznetsov was not quite so extreme, although still very much against FEZs, arguing that their benefits are not as great as many had previously claimed, and that the organizers of many FEZs no longer see them as positive, or controllable. He deplored the fact that the multinationals were very much in control, and could make FEZs compete against each other until the supposed benefits had been largely bargained away.⁷⁰ Although these two examples were directed at Free Economic Zones particularly, they applied to any measures which 'sold out' to the Western way of running the economy and the country. The support for these right wing groupings was fuelled by the economic hardships caused by the failures of Gorbachev's reforms. El'tsin, from the very beginning of his leadership, had to deal with this important level of antagonism to pro-Western economic policies.

Boris El'tsin came to be the most powerful man in the former Soviet Union after being carried on a wave of popular support for his opposition to Gorbachev, and his brave leadership of the anti-*putsch* forces. The euphoria very soon dissolved, however, with El'tsin this time being in charge of government, and therefore the new target for blame. The new President had the unenviable task of

⁶⁹ Leonard Geron, op. cit., p. 18, from Mikhail Antonov, 'Idti svoim putem', *Molodaia gvardiia*, no. 1, 1988.

⁷⁰ A. Kuznetsov, 'Svobodnye zony i natsional'naiia ekonomika', *MEMO*, no. 12, 1990, pp. 24-35.

trying to balance the need to preserve his popularity, against his stated aim of enacting more thorough-going reforms, with their inevitably unpopular results.

3.6 El'tsin's Economic Successes and Failures up to 1995, with Regard to Foreign Trade and Investment

It was made clear from the beginning of El'tsin's leadership that making a success of the economic reforms was the first priority. There has certainly been no lack of debate and initiatives. Between August 1991 and June 1992, the Russian Parliament passed over five hundred new laws concerning economic reform.⁷¹ This tendency continued into 1994, as shown by the President's announcement in May that one hundred decrees would be prepared, with thirty of them to be passed in 1994.⁷² Such prolific legislative activity is not without a negative effect, however. There was great uncertainty at home as well as abroad over which laws were still effective, and which ones were truly being enforced. Only once laws stop being introduced, and start being effectively implemented, can they have the desired effect on economic recovery. Nevertheless, despite the unpredictability of the legal situation, there were enough positive measures taken to ensure continued growth in the number of Western investment projects in Russia, and conditions for trade which more closely resembled those in Europe, although still presenting many unique challenges.

The remainder of this chapter seeks to determine what El'tsin has done to attract EU and other Western investors or exporters/importers, and how he has tried to assist Russian exporters. The material is separated into the three main goals of his economic reforms: privatization, macrostabilization and price liberalization, and convertibility. Finally this section covers the main changes in

⁷¹ According to Igor Ivanov, Russian People's Deputy and Chairman of the Sub-Committee on Finance and Currency, from a talk given at the School of Slavonic and East European Studies, University of London, 9 June 1992.

⁷² EIU, *Country Report — Russia*, London, 2nd quarter 1994, p. 21; and *BEE*, 20 June 1994, p. 7.

foreign trade policy itself, together with other legal changes affecting investment conditions.

Privatization

Privatization is widely considered the most important part of El'tsin's economic reforms. It is also of great importance to European traders and investors in Russia, for a number of reasons. The significance of being able to value enterprises according to market forces has already been noted; the need for managers of privatized enterprises to achieve profitability and to be answerable to shareholders also make denationalized enterprises more comprehensible and attractive to potential foreign partners. The political importance of the privatization programme was great, making the shift away from a centralized economy virtually irreversible; this in itself was priceless for Western business circles. Finally, especially in the latest phase, privatization paves the way for Western capital to directly help rebuild the Russian economy as equity partners, many branches of which can expect fast growth, and corresponding profits.

Until 1993, the pace of the privatization process was slow. Attempts had been made to speed up the process, for example in early February 1992, when the maximum time allocated for an authority to refuse an application for privatization was halved from a month to two weeks.⁷³ One of the more positive signs to date has also been the numerous and diversified regional privatization programmes. In the Moscow *oblast'*, for example, there has been an accommodation privatization drive at relatively moderate expense. By June 1992, however, less than 1% of the flats had been privatized. The pauperization of the population, and the

⁷³ RIA in English, 7 February 1992, in *SWB*, Weekly Economic Report, Former Soviet Union, 14 February 1992.

imperfection of the legislation have been blamed,⁷⁴ but the simple fact that rent was still by far the cheaper option remained the main reason for the slow uptake.

At the end of 1991, El'tsin had declared many over-optimistic goals for Russian denationalization. By the end of 1992, according to his 29 December decree, 50-70% of all enterprises would be privatized. His November decrees required that all trade and services enterprises open their own bank accounts by 1 January 1993, in order to become legal entities. In practice, many failed to fulfil this legal requirement in time. Even enterprises which were legal entities were still run by joint accounting offices, which meant that they were not in fact independent.⁷⁵ There had been virtually no successful instances of privatization of medium or large enterprises by the summer of 1992.

The large proportion of enterprises which were neither state nor private became increasingly problematic. Although the state still controlled 80% of interests in non-governmental corporations, and 60% in non-governmental partnerships, the managers were left mostly to their own devices. As they had no interest in the firm itself, owning no part of it, there was a tendency to be more interested in short term gain, and more open to corruption than ever. It also left much time for the planning of nomenklatura takeovers of enterprises, or 'spontaneous privatization'.

The main spur to the privatization programme was the distribution of vouchers to every member of the public, through 40,000 branches of savings banks throughout the country, starting in October 1992. Medium and large enterprises which had not yet been privatized were to be sold through voucher privatization, unless otherwise decided by the State Committee for Property (GKI). A minimum of 10% of shares in any 'mass' privatization had to be made available for vouchers.⁷⁶ To facilitate mass privatization all enterprises (except those deemed by the government to be unsuitable for privatization) had to re-

⁷⁴ ITAR-TASS, 18 June 1992, in *SWB*, Weekly Economic Report, Former Soviet Union 26 June 1992.

⁷⁵ Ibid.

⁷⁶ *The Financial Times*, 2 October 1992; and 'Ostankino' television, 1 October 1992, *What the Papers Say*, 2 October 1992.

register as joint stock companies with a corporate charter and a board of directors, even though 100% of equity was owned by the government. Following corporatization, its managers and workers could choose one of three forms of voucher privatization.⁷⁷ The first type of privatization offered free allocation of 25% of preferential (non-voting) shares to the collective of managers and workers, a further 10% of shares (with voting rights) were offered to workers at 0.7 times the nominal book value, with 5% of shares available to managers at the nominal price. It is important to note that the nominal book value is that which was estimated by auditors in 1992 (this is true for all three types of voucher privatization), meaning that in real terms the cost is extremely low, due to the effect of hyperinflation. Variant number one also granted 10% of any post-tax profits to the employees' collective. Variant number two offered 51% of stock to the employees at 1.7 times the nominal book value (in late 1993 this meant, in real terms, about 2% of actual value), with the employees also able to participate in the auctions selling off the remaining 49%; in this type of privatization, outsiders had to buy shares through property funds, or employees. Variant number three was intended for medium-size enterprises (200-1,000 employees). It called for a group within the enterprise to be delegated by the employees to take over the management for one year, being permitted to purchase 20% of stock at nominal value at the end of the year. The remaining shares could be bought by employees from the property fund, using the enterprise's profits. Although the Minister responsible for privatization, Anatolii Chubais, recommended the first variant of privatization, by late 1993 80% of privatized enterprises had used the second type.⁷⁸ These details are important for potential EU investors for two reasons. Firstly, any investor, especially if investing through equity, needs to know the composition of shareholders in their partner/investee company. The predominance of variant number two meant on one hand that investors could count on the extra motivation derived from a higher degree of shareholding

⁷⁷ Maxim Boycko, Andrei Schleifer and Robert W. Vishny, 'The Progress of Russian Privatization' in *Economic Transformation in Russia*, ed. Anders Åslund, London, 1994, p. 102.

⁷⁸ Martin McCauley, *op. cit.*, pp. 27-28.

amongst the workforce, but on the negative side there resulted an increased likelihood that granting important proportions of shares in a company to foreign investors would be vetoed by shareholders. More generally, though, this relatively high level of shareholding participation was likely to decrease the likelihood of renationalization, thus very slightly decreasing political risk.

Although originally all vouchers were to have been used by the end of 1993, this was extended first to the end of June, and then the end of July 1994. The Moscow City authorities ruled to extend voucher sales of shares in companies based in the capital until 1 January 1995.⁷⁹ After having sunk in price to just over Rb4,000 (\$10) in November 1992, and to Rb5,000 (\$5) in May 1993,⁸⁰ heavy voucher trading and domestic confidence in the privatization process pushed up the value of vouchers to over Rb31,000 (\$26) in November 1993.⁸¹

Land privatization was in need of a similar boost. By summer 1992, a mere 2% of Russian land had been privatized.⁸² This helps explain why, despite earlier reticence, El'tsin signed a decree in October 1992 which gave citizens the right to use vouchers to buy land or homes. The rights of land owners have progressively increased, up to the stage where, after another presidential decree signed in November 1993, Russians were allowed to freely buy, sell, rent and bequeath land, contrarily to the situation beforehand when land had to be owned for ten years before it could be resold.⁸³

By September 1993, 27% of Russian industry had been privatized, the highest figure for any former Communist republic or state;⁸⁴ by April 1994, this figure had more than doubled, as around 70% of large and medium-sized enterprises had been formally transferred to private ownership. According to the government-run Centre for Economic Analysis, by the end of the first quarter of

⁷⁹ BEE, 11 July 1994, p. 3.

⁸⁰ Maxim Boycko *et al*, op. cit., p. 105.

⁸¹ BEE, 22 November 1993, p. 3.

⁸² Grigorii Iavlinskii's Centre for Economic and Political Research, 'Spring '92 Reforms in Russia', *Moscow News*, no. 21, p. 6.

⁸³ BEE, 8 November 1993, p. 3.

⁸⁴ Martin McCauley, op. cit., p. 20.

1994 41% of Russian industrial workers were employed in the private sector, compared to 0.2% in January 1992; this does suggest, however, that it is the largest enterprises which still remained to be privatized.⁸⁵ By the spring of 1995 there remained 7,186 of the large state enterprises to be privatized.⁸⁶

Small scale privatization was at least as successful, following the decision to leave local authorities in charge of the cash auctions for their transfer of ownership, and in control of the proceeds.⁸⁷ By the end of September 1993, 61% of small enterprises had completed their privatization, although the rate was much lower in rural areas and in Asian Russia.⁸⁸ By April 1994, privatization of small businesses was virtually complete,⁸⁹ although many still had a minority state shareholding in 1995.

Post-voucher privatization consisted of straight auctions for cash of 25-30% of shares in remaining companies, with corresponding voting rights. Successful bidders were expected to invest the sum proposed over a period of three years, with an initial tranche of at least 20% to be payable immediately after the tender was accepted. Additional share offerings were expected to follow in companies needing extra capital, if this was acceptable to existing shareholders.⁹⁰ It was in these post-voucher sales of equity that the development of a respected system of auditing and an efficient interaction with shareholders started to be of tremendous importance. This is one of the areas where Western technical assistance (see chapter 4) has been very helpful, both in auditing itself, and in helping Russian auditors adopt international standards, thus gradually becoming more trusted both by potential investors and existing shareholders. This newly created possibility for Russian workers to reap the benefits of their labour through dividends should not be ignored. Although in the majority of cases shareholders are still obtaining little or no dividends on their shares, most of all because of the

⁸⁵ EIU, *Country Report — Russia*, London, 2nd quarter 1994, p. 23.

⁸⁶ EIU, *Country Report — Russia*, London, 2nd quarter 1995, p. 16.

⁸⁷ Maxim Boycko *et al*, *op. cit.*, p. 101.

⁸⁸ Martin McCauley, *op. cit.*, p. 29.

⁸⁹ EIU, *Country Report — Russia*, London, 2nd quarter 1994, p. 23.

⁹⁰ *Ibid.*

common practice to minimize official profits in order to minimize fiscal liability, foreign investors who gain influence in a company and who ensure that profits are declared in order to receive their yield through dividends will simultaneously be stimulating the workforce who have kept their shares.

As regards the possibilities for West European involvement in Russian privatization, the situation also improved considerably after early 1992. Although the 'Basic Provisions of the Programme for the Privatization of State and Municipal Enterprises in the Russian Federation for 1992' were very restrictive with respect to foreign investment, these Provisions were repealed in June of that year, and replaced by the full State Privatization Programme. In this Programme, the following conditions to foreign involvement in privatization were stipulated: if the foreign investor was the sole participant in the auction, competition or sale, the transaction could proceed, but the price had to be determined pursuant to a scheme determined by the GKI; foreign investors could take part in the privatization of trade, public dining and service enterprises or other small enterprises of industry, construction and automobile transport only by the decision of the local authorities; allowing foreign investors to participate in the privatization of fuel and energy complexes or specific mining enterprises required a decision of the Government of the Russian Federation or constituent republic when the principle of privatization was agreed.⁹¹ With the acceptance of the three above-mentioned modes of voucher privatization, however, access to shares became largely dependent upon purchases from employees.

There also remain some companies which are in a grey area, neither state-owned nor joint stock companies. Such companies can be majority-owned by its workers, without this ownership having been formalized through the issue of shares. Although the GKI seeks to abolish this type of half-way house, directors often try to retain the *status quo* precisely because they fear that their employees

⁹¹ W. E. Butler and M. E. Gashi-Butler, *Legal Aspects of Doing Business in Russia*, London, 1993, pp. 28-31.

could sell a controlling share to foreigners or to Russians who do not have the company's future at heart.⁹²

Many workers were likely to be reluctant to allow foreign investors to acquire a majority share, however, in fear of job-threatening restructuring. Another option deemed to be possible in 1993 was to approach a company before it was included in the mass privatization programme, and strike a deal with GKI. The Western investor could opt for a majority share, or the cheaper option of 33.3% plus one share, to ensure that another Western competitor could not later obtain greater control, short of buying it from the enterprise's workforce. There naturally remained the choice of simply establishing a JV with a company once it was privatized, which provided the significant advantage of having no responsibility for bad debts or environmental damage. One potential stumbling block is the requirement for 75% of the investors to approve such an asset transfer at the target enterprise's shareholders' general meeting.⁹³ Nevertheless, JVs have clearly continued to be the main vehicle through which Western companies have sought to become involved in production or trade in Russia, short of opening wholly-owned subsidiaries. With post-voucher privatization, however, the opportunities for simple portfolio investment, without seeking controlling shares or direct involvement in production or management, have been greatly facilitated. The American bank Credit Suisse First Boston (CSFB), which was appointed in 1992 to coordinate the first stage of Russia's privatization, was granted a securities licence in March 1994 which allowed it to trade and underwrite equity (as well as debt).⁹⁴ In its first few months of trading (still during voucher privatizations), CSFB was reported to have brokered \$300m worth of Russian equity.⁹⁵ The new opportunities granted by the latest stage of privatization are dampened, however, by the fact that brokerage fees are high, workforces may block Western takeover bids, and legislation on share ownership is still

⁹² This was still the case in the spring of 1996; the author met with such Directors in the Urals.

⁹³ *BEE*, 16 August 1993, p. 4.

⁹⁴ *BEE*, 14 March 1994, p. 12.

⁹⁵ *EIU, Country Report — Russia*, London, 2nd quarter 1994, p. 28.

ambiguous. A poll conducted by *Russian Economic Trends* classed legal disincentives as the most worrying type of barrier to investment, and within that category, fears about shareholder rights ranked highest. Nevertheless, at least \$748m of portfolio investment flowed into Russia in 1994.⁹⁶ Figures given by then Deputy Prime Minister Anatolii Chubais put the figure at well over \$2bn, peaking in June at \$500m per month, down to \$100m per month at the end of the year;⁹⁷ this is likely to be optimistic, however, as the RCB assessed the figure at \$602m, although Credit Suisse First Boston estimated over double this amount, at \$1,287m, from January to November.⁹⁸ Although the flow of portfolio investment slowed down with events in Chechnia, and later with concern over parliamentary and presidential elections, Western capital has nonetheless continued to be invested through the Russian stock market, and new Securities Funds have been set up in Moscow, gambling on an eventual boom.

The fact is that privatization has been the Russian government's greatest success in terms of market reforms. No other former Communist country has privatized so large a proportion of ex-state enterprises so quickly. Acquiring equity, even a majority share, in Russian companies was now a possibility for EU investors. Even at this early stage many EU investors took up this offer, despite the many uncertainties and bureaucratic hurdles; once the risk has lessened and the red tape reduced, EU equity investment can be expected to increase dramatically.

Macrostabilization and Price Stabilization

The Russian authorities' ability to control domestic money supply is naturally of great significance from the foreign investor's point of view. The levels of

⁹⁶ Government of the Russian Federation, *Russian Economic Trends* — 1995, vol. 4, no. 1, pp. 118-20; the \$748m figure is based on official balance of payments figure — the actual figure is likely to be higher.

⁹⁷ Ibid., p. 118.

⁹⁸ EIU, *Country Report — Russia*, London, 2nd quarter 1995, p. 35.

inflation that were reached after price liberalization, and the rate of exchange of the ruble as it became increasingly convertible, depended largely upon El'tsin's governmental policies on credit emission, interest rates, taxation, and budgetary expenditure. From a potential West European investor's perspective, astronomic domestic price rises are a strong disincentive for many reasons. One main problem of hyperinflation is the inability to predict costs; contracts with suppliers have proven to be no protection from this changeability, as in practice they have tended to be either renegotiated or simply not fulfilled. From a supplier's perspective, losses are inevitably made, even if longer-term contracts are avoided, as payments in rubles will have depreciated between the time when the price of a purchase was made, and the money actually transferred to the seller, who then has to convert it into either goods, investment capital or hard currency. Last, but not least, the political instability which is fuelled by hyperinflation is another potent disincentive to investment in Russia. The effect of macrostabilization on convertibility, and the use of hard currency as a tool against the repercussions of hyperinflation, are discussed in the next section.

The Soviet authorities' catastrophic monetary policy record was on the whole not improved upon by the Russian economic decision-makers in their first year. On the 23 January 1992 the Chairman of the Central Bank of Russia reported that the domestic debt of the FSU was Rb500bn, whilst Goskomstat had given a figure which was twice that only five weeks previously.⁹⁹ It should be stressed that contrarily to budget deficits in the West, which generally consist of state bonds and obligations, the Russian budget deficit normally consists of extra cash, adding directly to inflationary pressure.¹⁰⁰

The emission of cash itself proved to be fairly restricted, at least in the first three months of 1992. Despite Georgii Matiukhin's claim in January that this period alone would see more money printed than in the whole of 1991, in fact

⁹⁹ Matiukhin's (then Chairman of the Russian Central Bank) figures taken from Russian TV on 23 January 1992 (see *SWB*, Weekly Economic Report, 31 January 1992), whilst the Goskomstat figure was issued by TASS World Service in Russian, 24 December 1991.

¹⁰⁰ Franklyn D. Holtzman, *op. cit.*, p. 18.

amounts of cash injected into the economy were lower than in the last part of the previous year. The restriction of cash injections did not unfortunately mean a curtailment in money supply; credits continued to be granted, but there was simply not enough physical cash to spend them. The 'cash crisis' was at the centre of media attention for much of the first half of 1992; the general impression conveyed was that if only enough cash could be printed, the problem would be solved. Gaidar seemed to have abandoned his monetarist policy when he said in May 1992 that he hoped to reach Rb142bn in cash emission in June, approximately 2.5 times that of May, and that he also wanted to introduce Rb5,000 notes from July, and to increase the level of cash printing to Rb270-80bn per month by August.¹⁰¹ The fact that it took so long to take such simple measures as printing higher denominations, however, suggests that in fact the 'cash crisis' was a primitive way to limit the money supply, made possible by the fact that a very high proportion of personal consumption transactions in Russia were still conducted in cash.¹⁰²

Regardless of how much cash was being made available in early and mid-1992, the growth in credit would sooner or later be translated into inflationary pressure, short of all credit being indefinitely frozen and/or the existing ruble being abandoned for a new currency. Despite that fact, strict monetary control was given only lip-service. In theory, the Russian government's economic programme, adopted on 27 February 1992, cleared the way for a tightening of the money supply. Konstantin Kagalovskii, the plenipotentiary for relations with international financial organizations, had then made it clear that he wanted to bring monthly inflation down to 3% at most, by the last quarter of that year.¹⁰³ In fact, however, the amount of rubles being introduced into the economy continued to augment exponentially. From a level of Rb325bn in February 1992, total RCB credits increased to Rb485bn in March, Rb833bn in May, Rb2,009bn in July, and

¹⁰¹ Channel 1 TV, Moscow, 31 May 1992, in *SWB*, Weekly Economic Report, 5 June 1992.

¹⁰² Alan Smith, 1993, op. cit., p. 182.

¹⁰³ ITAR-TASS World Service in Russian, 27 February 1992, from *SWB*, Former Soviet Union, 29 February 1992 (SU/1317 B/2).

Rb3,117bn in August. This is the period which saw the greatest proportional increase in RCB credits, and in M2.¹⁰⁴

One main reason for the pressure to allow credits to grow was the inter-enterprise payment crisis. The practice of spending empty credit had become increasingly common. This process habitually started with a commercial bank granting credit which it did not have, with the recipient in turn spending this credit, regardless of its baselessness. This scenario was then copied, creating a long chain of enterprises counting on non-existent funds. Non-payments, both between enterprises and banks, and purely between enterprises, amounted to Rb764.3bn, in the first quarter of 1992, a twenty-three fold increase on the same period of the previous year. In other words, 37.4% of industrial output was not paid for.¹⁰⁵ The commercial banks which had brought themselves into debt in this way were not dissolved, but instead tended to be accorded credits by the Central Bank of Russia. This was done partly in the hope of avoiding panic in the new banks which could have resulted from commercial bank closures, and not least because of the pressure from the anti-market reform opposition not to do anything which would lead to widespread bankruptcies of enterprises affected by inter-enterprise debt. In this desire to protect enterprises caught in this conundrum, the conservatives were not necessarily being unreasonable, as Alan Smith notes;

perfectly viable enterprises have been caught up in debt chains and it is exceedingly difficult to ascertain the long-term prospects for an enterprise by looking at this short-run cash position. There is a fear that a single enterprise bankruptcy could lead to a major chain of bankruptcies [...].¹⁰⁶

On 3 April 1992, the Central Bank obtained permission from the government to take measures to allay the payments crisis, envisaging an increase in credits of

¹⁰⁴ M2 is the aggregate of currency in circulation, demand deposits and time deposits; figures from Government of the Russian Federation, *Russian Economic Trends — Monthly Update*, 30 April 1994, p. 11.

¹⁰⁵ Grigorii Iavlinskii's Centre for Economic and Political Research, 'Spring '92 Reforms in Russia', *Moscow News*, no. 22, p. 6.

¹⁰⁶ Alan Smith, 1993, op. cit., p. 182.

approximately Rb200bn. The following month, further increases in wages were approved, as were rises in pensions from Rb342 to 800-900 per month. Such freeing of budgetary control resulted in the massive amounts of credit listed above. Thus despite earlier talk of aiming at very strict monetary policy, Russia was, albeit by default, using a commonly prescribed method of reducing a currency overhang, namely allowing monetary supply to increase, but making sure that the increase in prices is proportionally greater. Thus the real average wage of the Russian population was 46% of its 1990 level in the first quarter of 1992, 44% in the second, 59% in the third and 65% in the last.¹⁰⁷ The problem is that whilst such an approach may be beneficial with medium or even high levels of inflation, the disadvantages of hyperinflation meant it was an inappropriate approach for Russia in 1992.

The rate of credit emission and monetary growth was lower in 1993, although still unacceptably high. Until September, only one month saw a rate of increase of total RCB credits of less than 10% (May, with 6%); the average monthly credit growth for those first three quarters was of 12.8%. The average monthly growth of M2 for the same period was 15.7%, bringing the total figure up to Rb28.7trn by the end of September.¹⁰⁸ Another significant destination of these credits was the former Soviet States; this capital was granted partly in order to maintain political leverage, and partly to prevent strategic suppliers collapsing, thus leaving their client Russian companies without essential inputs.

A clear sign that the government was still struggling to control inflation was shown at the end of July, when the authorities announced that all banknotes printed before 1993 would be withdrawn from circulation; enterprises were given one day to swap notes, individuals two weeks (this was later extended to 31 August by El'tsin). What was meant as an anti-inflationary measure seemed simply to have the effect of reducing confidence in the ruble, just as it had started to grow. It targeted both the shadow economy, and the former Soviet Republics,

¹⁰⁷ Government of the Russian Federation, *Russian Economic Trends — Monthly Update*, 30 April 1994, p. 13.

¹⁰⁸ *Ibid.*, p. 11.

but affected only some 12% of cash in circulation, whilst Pavlov's move had affected some 45% of cash. The proof of the damage done to confidence in the ruble came the next day, when the exchange rate had depreciated from Rb1,000:\$1 to Rb1,600:\$1 in the kiosks.¹⁰⁹

Despite counter-productive policies such as the currency reform described above, however, from the second half of 1993 the government's control over the macroeconomic situation seemed to increase significantly. In the last three months of 1993, the nominal increase in total RCB credits never reached 10%,¹¹⁰ and credits from commercial banks also appeared to have been greatly reduced. As a result, after having reached 18.8% of GDP in 1992, Russia's budget deficit for 1993 was halved.¹¹¹

Viktor Chernomyrdin, then relatively new as Prime Minister, although having maintained the impression that he was opposed to the monetarist approach of Egor Gaidar and Boris Fedorov, nonetheless continued to curb inflationary pressures in 1994. Almost certainly due to governmental pressure, in February the Central Bank ordered that the minimum capital requirement for new banks be increased from Rb100m to Rb2bn, effective from 1 March 1994; existing banks had until 1 January 1995 to comply, even though in March 1994, only 7% of the country's banks would have qualified.¹¹² This measure was aimed at curtailing the empty credits which fuelled the inter-enterprise debt, as was another decree in early 1994, which obliged enterprises to withdraw funds from their hard currency accounts if they were unable to meet their obligations from their ruble accounts. Nevertheless, the situation could only improve if at least some of the worst offenders, or those least likely to become profitable enough to ever repay their debts, were forced to dissolve. Rosgoskomstat had estimated that although some 8,000 firms had been officially recognized as insolvent, only eight enterprises had

¹⁰⁹ *BEE*, 2 August 1993, p. 5.

¹¹⁰ Government of the Russian Federation, *Russian Economic Trends — Monthly Update*, 30 April 1994, p. 11.

¹¹¹ IMF, 1994, op. cit., pp. 69-71.

¹¹² *BEE*, 21 March 1994, p. 6, and 28 February 1994, p. 6.

been declared bankrupt by the end of 1993. The Federal Bankruptcy Agency said in mid-February 1994 that another fifty companies were being considered for bankruptcy proceedings in arbitration courts.¹¹³ After years of vague threats about bankruptcy which were virtually never acted upon, the Prime Minister appeared to be pushing for a clearer and more forceful policy. Russian industrial plants were to be divided into three categories: i) those that managed to adapt to the new conditions, and whose output has started to grow; ii) those that had so far failed to adapt, but had obvious potential to do so (this was by far the largest group); iii) those which had no future and had to close down, a list of which was being prepared.¹¹⁴

Chernomyrdin's greatest achievement in the first half of 1994 was to succeed in passing his budget through the Duma in May; this budget provided for a deficit of 9.6% (Rb70trn) of GDP, not too far from the 6.5% requested by the IMF. The Prime Minister also succeeded in getting enough support to defeat proposals for a 67% increase in defence spending, which would have made adherence to the budget impossible.¹¹⁵

The government's interest rate and taxation policies have both been of relatively limited use, at least until late 1993, in the struggle to achieve macrostabilization. From the beginning, in 1991, taxation's role in the attempts to reduce the inflationary gap were bound to be limited for two main reasons. Firstly, the significant falls in production meant a decrease in fiscal income from corporate taxes. Secondly, as noted in the previous section, there was great ambiguity in the levels of taxation which had to be forwarded from the regions to Moscow, and a great reluctance on the part of autonomous republics and areas to maintain their fiscal contributions to the federal centre.¹¹⁶ These tendencies have prevailed up to the time of writing. El'tsin's Presidential decree of 22 December 1993 did, however, attempt to clarify the situation. The new maximum profit tax

¹¹³ *BEE*, 7 March 1994, p. 3.

¹¹⁴ EIU, *Country Report — Russia*, London, 2nd quarter 1994, pp. 16-17.

¹¹⁵ *Ibid.*, pp. 8 and 21.

¹¹⁶ Alan Smith, 1993, *op. cit.*, p. 119.

rate, which was raised from 32% to 38% (43% for banks), was now clearly divided: 13% went to the federal government, and up to 25% (30% for banks) was to be kept by the regional authorities.¹¹⁷ Despite this clarification of the legal position, however, regions have continued to ignore the requirements set by Moscow. For example, in April 1994 Irkutsk *oblast'* and Khabarovsk *krai* both declined to pay their federal taxes; meanwhile, Iakutia was pressing Moscow for greater retention of profits, in return for less central subsidization.¹¹⁸ The amount of loopholes in existing fiscal legislation, and the corruption of many officials, also shoulder part of the blame for the poor levels of taxation revenue. In the first quarter of 1992, only Rb30bn of the Rb228bn due in fiscal income from foreign trade was received, the rest being written off as 'privileges' granted to certain enterprises and local authorities; in total, an estimated Rb309bn was lost in this fashion between November 1991 and March 1992.¹¹⁹ Other figures suggest that the overall rate of tax collection is not so disastrous; one estimate of the level of uncollected taxes for the first three quarters of 1993 was 17%.¹²⁰

Interest rates, as a tool to discourage spending, have also been unavailable for most of El'tsin's time in power. During times of hyperinflation, the maintenance of a positive real interest rate is often impracticable; this was particularly the case for a government and central bank unused to the workings of a free market. In the first half of 1992, Georgii Matiukhin, then Chariman of the Central Bank, increased annual interest rates from 20% to 50%, which was a positive sign that played a part in strengthening the ruble *vis à vis* the dollar, as did the further increase to 80%;¹²¹ these could not compare, however, with the average inflation rate for 1992 of 1,353%.

In 1993, however, interest rates started catching up with inflation rates that were still consistently over 15% monthly (apart from December). The monthly

¹¹⁷ BEE, 7 March 1994, p. 8.

¹¹⁸ BEE, 7 March 1994, p. 3.

¹¹⁹ Grigorii Iavlinskii's Centre for Economic and Political Research, 'Spring '92 Reforms in Russia', *Moscow News*, no. 21, p. 6.

¹²⁰ Martin McCauley, *op. cit.*, p. 21.

¹²¹ ITAR-TASS World Service in English, in *SWB, Weekly Economic Report*, 1 June 1992.

interest rate in January was 9.9% (-12.8% in real monthly terms), in July it was 14.5% (-6.1%), and 18.4% in October (-2.1%).¹²² By December, interest rates became positive in real terms,¹²³ but the RCB's base rate kept rising. Thus by March the RCB's quarterly refinancing rate was 210%. Throughout spring and summer the rate fell in relation to the decreasing rate of inflation, and by the beginning of August the RCB three-month refinancing rate was down to 150%.¹²⁴

As mentioned above, privatization could not be used to substantially alleviate the inflationary pressure before prices were freed. Price liberalization was essential to solve many of the problems that had precluded efficiency under the Soviet system, as depicted in previous sections; the lack of reflection of supply and demand, the irrationality of the choice of imports and exports, the development of a black market and of corruption, the incessant need to queue, and many others. The new aims of economic reform also required free prices; only free prices could bring about the commodity convertibility which would make currency convertibility a possibility, and only they could make possible accurate estimations of the value of enterprises being privatized, or of those which need to be liquidated.

In January 1992, the Russian government freed 90% of retail prices and 80% of wholesale prices; by March 1992, price controls remained for only twelve basic foodstuffs, rents, public services and public transport. Predictably, the highest inflation came in the first month of price liberalization, January 1992; the month-to-month inflation rate was 245%, followed by 38% in February and 30% in March.¹²⁵

The other main factor discouraging a stabilization of prices after liberalization, apart from the high levels of credit being granted by the RCB and the natural tendency to spend rather than hold rubles, has been monopolies.

¹²² Martin McCauley, op. cit., p. 23.

¹²³ IMF, 1994, op. cit., p. 71.

¹²⁴ *The Guardian*, 2 August 1994.

¹²⁵ Alan Smith, 1993, op. cit., pp. 178-79.

Monopolistic state enterprises have on the whole reacted to reduction in demand not by cutting prices, but by cutting output. Thus despite the freeing of prices, food output declined by 28% in the first quarter of 1992, footwear by 21%, televisions by 28%.¹²⁶ This was made possible by the fact that whilst tight monetary and fiscal policies squeezed the retail sector and exposed consumers to tightening budget constraints, enterprises still enjoyed easy access to credit. This, combined with the fact that so many large Russian enterprises were monopolies, meant that managers could simply restrict output and increase prices.¹²⁷ Despite the extremely high propensity to spend which is triggered by such hyperinflation, especially considering the fears of the effects of the high levels of money supply, it is interesting that in the first quarter of 1992 the increase in wholesale prices was greater than that of retail prices, which suggests cost-push inflation. The combination of free prices but still state-owned retailing outlets created a situation where many shops left their food to rot rather than bring prices down, after they had overestimated demand.

Strong and effective anti-monopoly regulations needed to be imposed not only at large enterprise level, but with street trading as well. There have been widespread reports of producers attempting to sell their products on street stalls or markets, and being chased away by thugs protecting the interests of other traders. For small shops and kiosks, there is a well-documented need to pay a significant cut of profits to mafia-type protection rackets, and this discourages not only traders from doing business, but potential producers from setting up workshops or small enterprises. Such oligopolistic conditions allow prices to stay much higher than necessary. The Russian government has not been unaware of the problem. El'tsin issued a Presidential decree on 3 February 1992, stating that all enterprises were allowed to sell goods not specifically banned, that local governments should encourage free enterprise, and ensure that there are suitable facilities for street

¹²⁶ Grigorii Iavlinskii's Centre for Economic and Political Research, 'Spring '92 Reforms in Russia', *Moscow News*, no. 21, p. 6.

¹²⁷ Alan Smith, 1993, *op. cit.*, p. 197.

markets to be safe and attractive.¹²⁸ There have been some examples of popular markets, where access is clearly available to all, but these gigantic boot sales are not sufficient; they are infrequent, and overcrowded, but most importantly they are very small-scale. Any trader wanting to go a stage further and to open his own outlet is still likely to be faced with protection rackets. By mid-1994, the situation appeared to have begun to stabilize in Moscow, but only in as much as the jurisdiction of particular 'mafia' groups had become clearer, as had the rates which they demanded. In other cities, the fear and uncertainty remained at previous levels, continuing to act as an extremely strong disincentive to new types of production or services.

Yet whilst mafia-type oligopolies have increased in importance, the monopoly of the state in the supply sector has virtually disappeared. This took some time; in the spring of 1992 it was reported that despite Gaidar's pledge to the IMF that by the end of 1991 state orders would be virtually abolished, they in fact remained widely in operation, and the old distribution system was intact in many regions of Russia. A new sort of state order had also appeared, as local authorities often claimed 10-15% of the volume of their area's industrial output for inter-regional barter trade. Wholesalers frequently faced republican limitations to the prices they could charge, or even to which customers they could sell; middlemen likewise faced restrictions.¹²⁹ Despite these set-backs, commodity exchanges have gradually taken over as the main way to acquire supplies, together with direct contacts with suppliers. Newspapers such as *Kommersant* have been printing user-friendly charts of the rates for metals, energy products, wood and other goods at commodity exchanges since 1991. Television and phone exchanges of goods have also been popular, especially for cars and apartments. The downwards pressure on prices created by the more open competition permitted by the increasing number of exchanges was often more than compensated for by the increased access to world markets. Thus

¹²⁸ RIA, in English, 3 February 1992, in *SWB*, Weekly Economic Report, 14 February 1992.

¹²⁹ Grigoriĭ Iavlinskii's Centre for Economic and Political Research, 'Spring '92 Reforms in Russia', *Moscow News*, no. 21, p. 6.

between January and September 1993, most goods continued to approach 'world' prices, the commodity exchange price of petrol going from 37% of world prices to 58%, aluminium 41% to 65%, and wheat from 47% to 54%.¹³⁰

For all of the reasons elaborated upon above, prices on the whole continued to rise long after liberalization, albeit at a much slower pace than in the first month. Apart from the period between May and September 1992, and again in April-May 1993, the monthly increase in the consumer price index remained above 20% until November 1993.¹³¹ Nonetheless, the overall rate of inflation (still of consumer prices) was reduced in 1993, from the 1992 rate of 1,353%, to 896%.¹³² Although there was some expectation in mid-1994 that a new loosening of credit emission was likely to bring interest rates up slightly before the end of the year, Russia managed to remain close to the IMF's target monthly consumer inflation growth rate of 7% by the end of the year, ensuring credits for 1995 (see Chapter 4). This stabilization of the rate of inflation is clearly a precondition to any great increase in EU and other investment in Russia. A study done by the EBRD, compared the number of foreign investment projects *per capita* (in millions) in 1994 to the logarithm of inflation in that country in 1993. The results showed a very strong correlation between the two, with six out of nine countries with an inflation logarithm of under two having over ten projects per million inhabitants, whilst no country with an inflation logarithm of over 2.5 had more than five FDI projects per million inhabitants.¹³³ Thus the relative stabilization of inflation in 1994, especially in the summer, will have been a significant motivating factor for potential EU investors.

¹³⁰ Martin McCauley, *op. cit.*, p. 23; in the examples given in this source, there were two exceptions: crude oil went from 29% to 28%, whilst sugar distanced itself in the other direction, going from 129% of world prices to 152%.

¹³¹ Government of the Russian Federation, *Russian Economic Trends — Monthly Update*, 30 April 1994, p. 10.

¹³² IMF, 1994, *op. cit.*, p. 126.

¹³³ EBRD, *Transition Report*, London, 1995, p. 85-86.

Ruble Convertibility

The achievement of a very high level of internal convertibility in Russia has probably been the most important reform measure in terms of opening up the Russian economy to the world market. What Gorbachev's decrees did in theory — allowing any enterprise to deal in foreign trade — convertibility achieved in practice, although still limited to varying extents by tariffs, licences and quotas. Convertibility also works in tandem with free prices to determine in which commodities Russia has a comparative advantage, and which ones should be imported. Convertibility not only increases the possibilities for Western businessmen to operate in Russia, but it also increases demand from the increasing number of Russian traders buying on international markets, reflecting a level of demand for Western goods which is only now possible. Most importantly for Western entrepreneurs, convertibility makes viable the exchange and repatriation of ruble earnings from products produced in, or exported to, Russia. It reduces the need for barter trade, which was not only complicated, but sometimes forbidden. The internal convertibility of the ruble in terms of hard currency is complemented by the ruble's commodity convertibility (free availability of merchandise for rubles), achieved due to price liberalization and the decentralization of the supply side of the economy, and by a high level of capital convertibility (rubles being acceptable for investment or other capital transactions),¹³⁴ although the latter has been affected by high rates of inflation.

Achieving this level of convertibility was not without its problems and delays. From late 1991 until mid-1992, the situation was complicated by the continued operation of a multiple exchange rate. There was one extremely high rate for centralized imports (Rb5.4:\$1); a special market rate, mostly used for the replenishing of Russia's currency reserves (Rb55:\$1); the 'market' rate, established weekly by the Central Bank of Russia for transactions with authorized

¹³⁴ Alan Smith, 1993, *op. cit.*, p. 45.

banks, also artificially high (Rb100:\$1);¹³⁵ the free market rate, which can be divided into the cash rate and the money market exchange (non-cash) rate; and finally the black market rate. In another positive step towards normalization of ruble convertibility, President El'tsin issued a decree stating that from 1 July 1992, only the free market exchange rate was to remain in operation, calculated by the Central Bank on the basis of the rates achieved at auctions in the previous week. The rate charged by commercial banks was obviously slightly higher, providing a profit margin. Already before this measure, as more and more banks and kiosks had been selling hard currency, including certain branches of the central Sberkassy (savings banks), the black market rate had come down to a level only slightly more generous (by about 25%,¹³⁶ in May 1992) than that of the banks. This unification and liberalization of the exchange rate meant that the cost of any investment or expenses in Russia became much easier to calculate for foreigners, not only in terms of convertible currency, but also in terms of rarity value of whatever is being purchased.

Another destabilizing factor was that the Russian Central Bank did not always make its policy clear enough. On 16 January 1992, for example, the All-Russian Exchange Bank suspended its hard currency auctions, as it expected new hard currency legislation.¹³⁷ The artificiality of the auction rate was reduced when in May 1992 the Central Bank once again allowed other banks to deal in non-cash hard currency trade. This both extended the number and type of entities dealing at the auctions, and reduced the extent to which the Central Bank could affect the rate through hard currency injections. Such interventions were the norm, and in the second quarter of 1992 they could go up to \$15m¹³⁸ per auction, although they were normally lower, for example \$3.5m on 12 May, or \$7-8m on

¹³⁵ These figures are given in Grigorii Iavlinskii's Centre for Economic and Political Research, 'Spring '92 Reforms in Russia', *Moscow News*, no. 21, 1992, p. 6.

¹³⁶ *Kommersant*, 19 May 1992.

¹³⁷ Postfactum in English, 25 January 1992, from *SWB*, Weekly Economic Report, Former Soviet Union, 31 January 1992.

¹³⁸ *Kommersant*, 23-30 March 1992, no. 13, p. 7.

14 May.¹³⁹ It is important to realize that this stabilization was being achieved without the G7 stabilization fund, which had not then been signed off.

By the spring of 1992, enough commercial banks had acquired the right from the Russian Central Bank to buy and sell hard currency cash to create a competitive downward pressure on the price of the dollar. Both foreign and Russian individuals could now freely go to commercial banks or currency kiosks to buy or sell cash currency. A more determining factor, which also strengthened the non-cash market, was the tight control of cash rubles being issued, as discussed above. In the early months of 1992 the rate of the dollar actually fell, and remained very strong until the summer. A. Potemkin, head of the Russian Central Bank's foreign currency administration, claimed that this fall in the ruble rate from June was a deliberate move to start lowering the level of Central Bank intervention;¹⁴⁰ presumably, the RCB could not afford to keep the MICE rate at a significantly higher level than the market cash rate for very long. Many questioned whether spending hundreds of millions of badly needed dollars on stabilizing the ruble so far had not been premature, but it must be remembered that it was extremely important to show that the ruble could reach a high level of domestic convertibility without crashing, increasing confidence both at home and abroad in both the currency and the economy as a whole. If the levels of credit from the RCB had stabilized in early 1992, the exchange rate could have survived.

The massive levels of credit being issued, compounded by the huge amounts of rubles flooding in from republics which were switching to their own currencies, meant that even the massive stabilization fund discussed by the G7 could not have saved the exchange rate in 1992. Already by August, total RCB credits had topped Rb3,000bn.¹⁴¹ Taking a hypothetical and slightly devaluated rate (compared to the MICE rate on 2 June of Rb112:\$1) of Rb150:1, the whole

¹³⁹ *Commerzant*, 19 May 1992, p. 14.

¹⁴⁰ *Izvestia*, 17 June 1992.

¹⁴¹ Government of the Russian Federation, *Russian Economic Trends — Monthly Update*, 30 April 1994, p. 11.

of the potential \$6bn stabilization fund (in other words worth Rb900 bn at this rate) would disappear in less than a year if one third of these credits were directed towards buying hard currency. Admittedly, the credits could not immediately be translated into dollars, as cash emission was restricted, and as corporate credits could only be exchanged by showing proof of a hard currency obligation; nevertheless, it was only a question of time before these credits became cash, which would in significant part be targetted at hard currency commodities. In other words, with Russian credit policy so loose, not granting a ruble stabilization fund is not something the EU or other multinational organizations should be criticized for in 1992-1993.

As undesirable as it may be to allow the exchange rate to fall drastically, it must be remembered that the real exchange rate (actual exchange rate in relation to inflation) is the most important parameter, especially for foreign investors. Figures for the whole of 1992 have no useful meaning, however, as they compare centralized prices with free prices, and a very restricted convertibility regime to a relatively open one by the end of the year; thus, no real conclusions can be drawn from the fact that consumer prices rose ten times faster than the MICE exchange rate in 1992. A much more accurate impression may be derived from the figures from July, when the exchange rates were unified, and the MICE rate was a much truer reflection of actual supply and demand, and because the shock of price liberalization had been largely absorbed. For the period from July to December 1992, however, the exchange rate grew faster (158%) than the rate of inflation (136%), meaning that the ruble was devalued by 16% in real terms for that period. For 1993, however, the ruble appreciated by over 200% in real terms.¹⁴² In other words, Russia's GDP, in relation to that of all other countries dealing in hard currency, would have doubled if it had remained the same in terms of 1992 rubles.

¹⁴² MICE exchange rates and consumer price indices taken from *Russian Economic Trends — Monthly Update*, 30 April 1994, pp. 10-12.

The Moscow Inter-Bank Currency Exchange continued to be the Russian government's main vehicle to gradually increase non-cash convertibility. By the beginning of 1994, only five other regional exchanges were licensed by the RCB to deal in hard currency. Trade was through actual auctions, lasting only an hour. All bids had to be submitted in advance, with a broker moving the price to clear the market.¹⁴³ Thus although the average daily trading volume had reached \$80m-100m by the second half of 1993, it was still impossible for a company to put in a very large order without distorting the market. The annual turnover in 1992 was estimated at \$2-4bn in 1992, whilst it rose to \$15bn in 1993, and was expected to reach \$25bn in 1994. One main reason for the increase in trade in the second half of 1993 was the rule introduced requiring exporters to convert all of the mandatory 50% of export income through exchanges, whilst previously 30% went to the RCB. By 1 September 1993, Western organizations which were not Russian legal entities (for example representative offices) could also buy or sell foreign currency at the MICE,¹⁴⁴ albeit still through an intermediary broker bank. By July 1993, out of a total of some 1,700 commercial banks in Russia, some fifty-five to sixty had permission to engage in foreign exchange operations. There has been a great improvement in the efficiency of the banks which participate in the currency exchange. Whilst in 1992 there were reports of currency transfers using these banks often exceeding one month, by late 1993 it was reported that rubles deposited with such a broker bank could normally be transferred to a hard currency account within twenty-four to thirty-six hours, thus minimizing exchange rate exposure. On larger amounts, however, delays were likely unless some warning was given.

By early 1994 there was general satisfaction amongst Western business people in Russia with the level of convertibility, although the main complaint remained that foreign firms still had to work through broker banks, where a

¹⁴³ *BEE*, 12 July 1993, p. 7.

¹⁴⁴ Martin McCauley, *op. cit.*, p. 26.

commission rate of 5% was the norm; at the time of writing, the Russian banks still enjoyed a monopoly position.

Despite the undeniable success of the currency exchanges in achieving a very high degree of convertibility, the fact remains that the restricted access to money markets and a very poorly developed market in government obligations are two factors which help keep the exchange rate below its long-term equilibrium value. Until the ruble ceases to be undervalued, controls over foreign trade can be justified.¹⁴⁵

The banning of the use of hard currency cash in retail outlets was aimed at achieving a higher equilibrium rate for the ruble. This controversial measure had often been talked about in the previous two years, but it was finally enacted in January 1994. Despite the newfound convertibility of the ruble, continuing hyperinflation ensured that holding rubles was still not desirable, and thus led to a further dollarization of the Russian economy. As an example, dollar deposits held in Russian commercial banks were estimated at \$804m in January, whilst by July 1993 they had grown to \$16,600m.¹⁴⁶ One official estimate put the proportion of savings of the Russian population which was kept in hard currency at 61.8% for 1994.¹⁴⁷ These figures are certain to greatly underestimate dollar holdings, as Russian banks continue to be widely mistrusted and underused, most of all where hard currency is concerned. The use of dollars had become very common, not only in Western shops, but for virtually any large transactions.

During the period when the hard currency cash ban was merely a rumour, the general impression of Western businessmen was that it would be disastrous. When it actually happened, however, most were very quick to adapt and to see the benefits. The effect was less daunting than it would have been in 1991 or 1992 because of the increased efficiency and turnover of currency exchanges, and also because non-cash hard currency transactions, both in retail outlets and

¹⁴⁵ Alan Smith, 1993, op. cit., p. 187.

¹⁴⁶ Martin McCauley, op. cit., p. 22.

¹⁴⁷ Government of the Russian Federation, *Russian Economic Trends* — 1995, vol. 4, no. 1, p. 115.

between banks, were still permitted. Retail prices could even still be quoted in dollars. The ban has created an impetus for retailers to adopt credit card systems (which can still use hard currency), including Russian ones, such as that run by the Stolichnyi Bank, which reportedly had 20,000 users by the beginning of 1994. Some retailers, such as the Swiss-Russian JV Sadko, planned to develop their own credit card system.¹⁴⁸

Most of the representatives of Western companies who were interviewed by *Business Eastern Europe* believed that, despite the short-term problems created, the compulsion to do business in rubles would bring Russia in line with other developed single-currency economies. One of the main drawbacks has been to hold large amounts of cash rubles, with the very likely result of losses as long as inflation remained high. Another concern, expressed for example by Sadko, was that the capacity to deal with the extra amount of rubles in the currency exchanges, despite their progress by the end of 1993, would still be insufficient.¹⁴⁹ In fact, though, by mid-1994 it seemed that the currency exchanges were coping very well.

Like a Western currency exchange, the Moscow rate has also become sensitive to the international situation. In late 1991 and early 1992, for example, whenever the '\$24bn' G7 package seemed closer to being confirmed, there was a tendency for dollar demand to fall, in expectation of its price falling with the \$6bn stabilization fund;¹⁵⁰ conversely, unsatisfied noises from the West have tended to decrease the ruble's value. As in any other developed country, as far as the markets are concerned, the perceived economic and political situation is more important than that which is real. This heightens the need for Western countries and financial institutions to show confidence in the stability and the prospective growth of the Russian economy.

The readiness of the market for the IMF stabilization fund was finally achieved by the end of 1994. Despite the severe political turmoil in September

¹⁴⁸ *BEE*, 10 January 1994, pp. 1-5.

¹⁴⁹ *Ibid.*, p. 5.

¹⁵⁰ *Kommersant*'', 6-13 April 1992, p. 8.

and October 1993, RCB intervention meant that the ruble fell less than 20%, from Rb992:\$1 on 31 August to Rb1,181 on 1 November. In January 1994, the resignation of Gaidar and Fedorov put more pressure on the ruble, and the RCB reportedly spent \$1bn to limit its fall to 24%, from Rb1,255:\$1 to Rb1,560:\$1, whilst in March the Central Bank was buying dollars back.¹⁵¹

Despite the continued fall of the ruble in nominal terms in 1994, and the fact that it had dropped to around Rb3,000:\$1 by the end of the year, it had appreciated in real terms in the first quarter, and continued to do so. For foreign traders and investors, this meant yet more profitability being lost on exporting goods to Russia, yet increased the appeal of investing in Russian production.

Although many Western businessmen were very slow to realize that they could convert their ruble earnings for hard currency, which could then be repatriated, it has now become the norm. As long as the Western partner owns more than 30% of their concern, they may repatriate the currency profits without incurring any additional taxes. The joint venture or Western subsidiary must be fully registered with the Russian authorities to be able to repatriate such converted profits; here again there has been potential for bureaucratic wrangles, as well as bribery and corruption. Already by mid-1993, the trend was moving away from simply maintaining a representative office in Russia and invoicing sales in hard currency directly from abroad, and towards establishing local legal entities which sell goods for rubles, use currency exchanges, repatriate profits, and buy new merchandise to repeat the cycle.¹⁵² Still in March 1994 *Business Eastern Europe* was commenting on the 'increasing liquidity of monetary exchanges, which allows companies to repatriate profits relatively painlessly'.¹⁵³ Thus, the major obstacle of non-convertibility, despite the remaining imperfections, had *grosso modo* been solved, greatly stimulating the involvement of Westerners in Russian production and trade. Although very many EU

¹⁵¹ EIU, *Country Report — Russia*, London, 2nd quarter 1994, p. 25; exchange rate figures (of the MICE) from Government of the Russian Federation, *Russian Economic Trends*, op. cit., p. 12.

¹⁵² BEE, 12 July 1993, p. 7.

¹⁵³ BEE, 28 March 1994, p. 1.

investors remained unaware of the level of convertibility and opportunity to repatriate profits, or feared the need to register and thus become a target for the Russian tax inspectorate and other authorities, the fact nevertheless remains that these most damaging obstacles to foreign trade and investment had practically been resolved.

3.7 Foreign Trade Policy Reform, and New Conditions for Foreign Investment

Having examined aspects of Russia's reforms which, despite affecting foreign trade and investment, were aimed primarily at rejuvenating the domestic economy, attention can now be turned to El'tsin's policies which were directly targetted at foreign entrepreneurs. First the new regime affecting trade into and out of Russia will be analysed, followed by an examination of the conditions for foreign investment inside Russia.

The previous section noted the increase in categories of goods which required export licences after December 1989. First the list of goods needing licences was shortened in the first half of 1992, then more new regulations were introduced in the second quarter of that year, intended to set up a uniform procedure for the issuing of export licences. Export quotas were to be defined by the Russian Ministry of Economy and Finance, and these quotas were to be confirmed by certificates, the owners of which had the right to obtain export licences. Free sale of certificates was allowed. Certificates could either be specific to the country of the purchaser, or open; all certificates were valid for up to one month. Licences were to be issued to the owners of certificates against presentation of agreements for delivery of goods and signed export contracts.¹⁵⁴ Although El'tsin's team had

¹⁵⁴ Postfactum in English, 8 January 1992, from *SWB*, Weekly Economic Report, Former Soviet Union, 10 January 1992.

pledged to abolish all non-tariff export restrictions in the summer of 1992, the above system of quotas and licences has continued, for some goods, up to the end of 1994.

Non-tariff restrictions were not the only hindrance to exporters, however. On top of profit tax (see below), exporters also faced the mandatory exchange of 50% of their export revenue. This was especially damaging before the exchange rates were unified in mid-1992, when exporters had to sell 40% of their hard currency profits at the 'special' rate (Rb55:\$1), and to sell a further 10% at the full market rate. In certain sectors, such as that of precious metals, even larger proportions of hard currency profits have to be sold to the state. After July 1992, as explained above, 30% of profits went to the RCB at their market-based rate, and 20% directly to an exchange, and by the autumn of 1993, the entire 50% went directly to an exchange. The confusion and obstruction caused by the licence system and the mandatory exchange, coupled with the overall decreases in production, resulted in a 20% fall in Russian exports in the first quarter of 1992, in relation to the previous year.¹⁵⁵

The political ambiguity of 1993 was reflected in foreign trade policy. On the one hand, the number of organizations which were granted licences to export goods considered to be 'strategic' was greatly reduced; by September, only four organizations had licences to export oil, five for petroleum products, and five for non-ferrous metals. Any JVs wanting to export such goods had to seek exceptions to the regulation.¹⁵⁶ On the other hand, the number of goods for which export quotas and licences were needed was reduced, for example timber products, coal, mineral fertilizers and some non-ferrous metals were all exempted by December 1993. As far as imports were concerned, obstacles were still minimal, as long as customers with hard currency could be found. Import tariff rates were relatively low, over 10% only for chocolate (30%), cigarettes (15%),

¹⁵⁵ Grigorii Iavlinskii's Centre for Economic and Political Research, 'Spring '92 Reforms in Russia', *Moscow News*, no. 21, 1992, p. 6.

¹⁵⁶ *BEE*, 6 September 1993, p. 3.

ethylized spirits (150%), drinking spirits and wines (100%), clothes and footwear (15-30%), consumer electronics (15-25%) and cars (25%).¹⁵⁷

This situation was not to last, however. Even while Gaidar was still Deputy Prime Minister, his policy had shifted to one of 'sensible protectionism'. Although cynics argued that this was merely a move to increase political support, Gaidar argued that contrarily to the situation at the outset of Russia's economic reforms, a level of internal competition had developed, which meant that imports could be curtailed without pushing prices upwards. He believed that at that stage of reforms many Russian industries needed protection, although he vowed to resist pressure to protect industries where Russian producers have a monopoly.¹⁵⁸ Such protectionism towards imports and encouragement of exports, at the beginning of a country's economic rebirth, has a precedent in the case of Japan; in the Japanese scenario, the emphasis was likewise on protecting only industries which had effective internal competition.¹⁵⁹ Thus import duties were significantly raised, with effect from July (after March had been abandoned as the starting date) 1994. The tariff rates for all types of goods increased, apart from leather goods, perfumes, video cassettes and knitwear. The only goods to have rates of under 15% were grain (1%), yogurt (10%), sunflower oil (10%), tomatoes and cucumbers (10%), and raw sugar (1%).¹⁶⁰ The 50% surcharge on import tariffs in the case of barter goods, introduced in January 1993,¹⁶¹ remained operative.

The equivalent measure for exports was to abolish export quotas and licences. Such a move had been forecast in 1993, and was enacted in July 1994. Even oil and petroleum products, as well as rare metals, no longer required export licences. The Russian authorities admitted that, especially for oil, the system of quotas had been a source of massive profits, through corruption and illegal

¹⁵⁷ *BEE*, 28 March 1994, p. 1.

¹⁵⁸ *The Financial Times*, 24 November 1993.

¹⁵⁹ Alan Smith, 1993, op. cit., pp. 224-25.

¹⁶⁰ *BEE*, 28 March 1994, p. 1.

¹⁶¹ *BEE*, 21 June 1993.

exporting of oil bought at domestic prices.¹⁶² Equally as important is the fact that most export duties were lowered, although that for oil was still substantial at ECU15 (\$18.3) per tonne.¹⁶³ This helped not only oil companies, but countertrade opportunities as well. Inevitably, the freedom to export still remained restricted in other ways, as the domestic price was still well below the average European level. In practice, the monopoly over the pipeline network was again used to limit export levels, but nevertheless domestic prices were pushed up to a level very close to that in Europe (see Appendix Two).

The increased import tariffs, together with the ever-strengthening real rate of the ruble and the gradual disappearance of import subsidies, have meant that exporters considered more and more seriously the possibility of producing and sourcing in Russia, the conditions for which are described below. For those traders still exporting from the West, the above factors increased the need for countertrade arrangements. One of the approaches on the increase was 'advance purchase', where a Western exporter first bought goods from Russia in hard currency, through the potential Russian client; the hard currency was usually kept in an escrow account, to ensure that it was used for the intended Western exports, whilst the Western exporter obtained his profits from selling the Russian goods. One major problem with this solution, however, was that rigorous restrictions on offshore accounts mean that escrow accounts needed special approval from the RCB or other government officials, which was difficult and time-consuming to obtain; many Western banks were also reluctant to open escrow accounts because of potential sequestration claims on Russian assets. Another common approach was pre-financing, needed especially in deals where the Russian producer may have needed the Western equipment to produce the goods which will pay for the foreign technology. In such cases, most often, the Russian importer eventually sent goods to a Western buyer, which paid for the Russian goods in hard currency to a Western bank (probably guaranting or financing the original export) which,

¹⁶² EIU, *Country Report — Russia*, London, 2nd quarter 1994, p. 22.

¹⁶³ *BEE*, 18 July 1994, p. 2.

having received a payment instruction from the Russian producer, transferred the payment to the original Western exporter, having retained a fee.¹⁶⁴ Another alternative to finding the financing for Western exports was to find a Russian exporter with the necessary hard currency resources, and willing to pay for the imports of another Russian enterprise, in exchange for a beneficial deal on the products of this importer. This was done, for example, by the Norilsk Nickel Plant, which financed the importing of brick-making equipment for a Siberian plant, which in turn secured local grain products which were supplied to Norilsk at favourable prices.¹⁶⁵

Helping both countertrade and simple export-for-money operations was the increasing use of letters-of-credit (L/Cs). One practice on the increase has been that of exporting to the Russian market via straight L/C business, with Russian firms who have hard currency export proceeds in Western bank accounts; this practice is illegal, but given the instability of the ruble, it has become common. Using L/Cs based on Russian banks is the legal option, but Western banks' confirmation of such letters-of-credit was expensive at 6-7% of the transaction. Some banks were willing to use L/Cs without Western confirmation, but this almost never happened on amounts over \$100,000.¹⁶⁶ This practice has been increasingly used, however, as some Russian banks have emerged as particularly trustworthy.¹⁶⁷ In these cases the L/Cs are payable in Russia, and an additional five or six weeks are usually needed in order to transfer payments to a correspondent Western bank. In virtually all cases, the Russian bank will require 100% coverage deposit in counterpart rubles from the Russian payer before agreeing to the L/C. This variety of mechanisms enabling trade to occur, albeit at a relatively high price, has been of crucial importance in allowing imports as well as exports to keep increasing throughout 1994, the former increasing from

¹⁶⁴ *BEE*, 17 January 1994, p. 1.

¹⁶⁵ *BEE*, 16 August 1993, p. 2.

¹⁶⁶ *BEE*, 27 September 1993, p. 4.

¹⁶⁷ *BEE*, 3 January 1994, p. 2; the leaders in this field were Rosvneshtorgbank, International Moscow Bank, Dialog Bank, Mosbusinessbank, Credo-bank and Tokobank.

\$44.3bn to \$48bn, and the latter from \$33bn to \$35.7bn.¹⁶⁸ Again, however, trade would have been higher still had more EU and other Western importers and exporters been aware of these tedious details.

Despite the incentive provided by the changing foreign trade regime to invest in Russian production, the risks and disincentives of such a move remained very high. As noted above, the greatest fear has usually been that of political instability, of the possibility of the pro-market reforms being overturned. Whether it be the immediate uncertainty after the August 1991 attempted *coup*, the stalemate between Parliament and government in late 1992 and early 1993, the 'events' of September and October 1993, or the December 1993 elections where the extremist Vladimir Zhirinovskii collected an alarming proportion of the vote, there has always been much to worry about. Already by the end of 1994, investors were looking with trepidation to the Parliamentary elections expected in 1995 and the Presidential elections to be held no later than in 1996.

It has already been pointed out that some surveys put worries about legal disincentives first on the list of worries of Western investors. This is in part due to the changeability of Russian legislation, as also alluded to above, and which renders futile many long and expensive attempts to assess the risk involved in given projects. Another concern is that Russian laws are often ambiguous, perhaps on purpose, allowing significant freedom of interpretation; this, combined with the lack of an experienced and objective law enforcement system, often means that local officials can impose legal requirements on foreign investors as and when they feel the desire to receive fines or bribes. There are many concerns over weak contract law, as well as over shareholder rights. The latter are not helped by the fact that there is no common practice of keeping the share register of companies with an independent share registrar.¹⁶⁹ The lack of

¹⁶⁸ EIU, *Country Report — Russia*, London, 2nd quarter 1995, p. 23.

¹⁶⁹ Government of the Russian Federation, *Russian Economic Trends*, op. cit., p. 123.

trust often shown by Russian business people themselves in their legal system does not help the situation.

Of the more tangible concerns of Western investors, Russia's external debt, both governmental and commercial, has also been on entrepreneurs' minds. Although Russia has more or less followed repayment arrangements reached in the last few years with the Paris and London Clubs of creditors, these have been very lenient, as a result of poverty claims from the Russian side. In late 1991 and early 1992, threats by Matiukhin to declare Vneshekonombank bankrupt, or the statement by Egor Gaidar (then Finance Minister) that Vneshekonombank had only \$60m in credit remaining, did nothing for Russia's new credit standing. There were plenty of reasons to keep Western financial organizations and credit funds reluctant to support projects in Russia.

The chaos regarding the respective jurisdictions of the federal and regional authorities brought yet more uncertainty into the equation of investment in Russia. Whilst in some cases the greater willingness of the regional governments to strike a deal has helped Western companies (see Appendix Two), at some stage Moscow normally still had to be dealt with where exporting to Western Europe was concerned, in which case regional agreements could not contravene federal principles. One of the Western companies to have suffered from this problem is Star Mining (of Australia), which pledged to pay \$20m to the joint-stock gold mining company Lena Gold, in which it holds one third of the shares. Star Mining originally planned to pay this \$20m in 1993, and invest another \$105m in 1994, but in fact only in the spring of 1994 was the first \$5m tranche disbursed. The delays have been due to disagreements between Russia's central government and the Irkutsk regional government, over control of the project. Star Mining planned to invest a total of \$250m to raise production six-fold in six years, but in mid-1994 the future of the project was uncertain.¹⁷⁰

Different obstacles also emerge from the need to deal with Russia's regions. Due to the country's geographic immensity, and the underdeveloped

¹⁷⁰ *BEE*, 16 May 1994, p. 9.

infrastructure and transport organization, distribution is a major problem for Western companies trying to establish a presence in Russia. The care-free approach to service that was inherent with the supplier's sovereignty under the Soviet system, means that finding a network of effective retailers and achieving an adequate level of product and customer support has also been very time-consuming, expensive, and only partially successful. Companies have found that, unless they are simply aiming for an enclave presence, there is little point in advertising before the above goals are reached.¹⁷¹

Another significant deterrent, although less so than for Russian traders and producers, is that of the mafia-type organized criminals. Such was the level of worry amongst foreign businessmen, following a rise in the number of muggings and death-threats to foreigners, that in early 1994 British businessmen held an unprecedented meeting with Russian police chiefs to discuss the matter of defending themselves; briefings on the same issue have also been offered by the security officer at the British embassy. Such is the power of organized crime in some areas that the line between the 'mafia' and the authorities becomes blurred. An example is provided by the example of the Spanish wine firm Cordoniu, which had 100 lorryloads of its produce stolen from a warehouse in St Petersburg. When representatives of the firm went to see the head of the 'economic crimes' branch of the Ministry of Security, they were given the phone number of a group of people, who turned out to have 'control of the merchandise in question'.¹⁷²

By 1992 taxation was another factor which helped keep potential investors away. The tax holidays offered under Gorbachev had disappeared, as had the special tax rate for companies with more than 30% ownership. Furthermore, from March 1992 foreign businessmen faced a maximum tax rate (of their 'worldwide' income) of 60%, on annual incomes of over £2,500;¹⁷³ the impact was lessened, however, by the fact that bills could be paid first at the official rate (Rb0.67:\$1) and then at the commercial rate (Rb2:\$1), until the rates were

¹⁷¹ *BEE*, 25 October 1993, p. 1.

¹⁷² *The Sunday Times*, 13 March 1994.

¹⁷³ *The Daily Telegraph*, 1 June 1992.

unified, whilst in fact rubles could be bought much more cheaply on the black market.¹⁷⁴

In the second half of 1992, though, the maximum income tax rate for foreigners was reduced and by 1993, it was 30%. The corporate profit tax was 32% (in certain cases 45%), and the employer payroll/social security tax was 39% of payroll. Also to be considered was the VAT (of 10% or 20%), an excise tax on certain goods, varying from 10% to 80%, and a withholding tax of either 6%, 15% or 20%.¹⁷⁵ The Presidential decree of December not only divided profit tax revenue more precisely between the centre and the regions; it also introduced a 3% 'special purposes tax', intended to support priority areas of the economy, such as coal-mining and agriculture. Of most damage in this decree, however, was the 23% tax imposed on non-banking foreign loans; intending to crack down on companies seeking to disguise trade payments as loans (which were never repaid). The problem is that this tax has also been applied to offshore financing of Western companies, as a result of which the amount of capital being injected into such ventures has been greatly reduced.¹⁷⁶ On the positive side, the December decree reintroduced the concept of tax holidays for foreign JVs. The applicability of tax holidays was defined more precisely in decree number 1004 in May 1994: the holiday was to be of a duration of three years; it was to be available only to ventures with an initial investment of at least \$10m; the enterprise involved had to be registered after 1 January 1994, and had to be involved in 'productive activities'; such ventures had to have a paid-in foreign investment of at least 30%.¹⁷⁷ Apart from the rather restricted benefits in terms of tax holidays, decree 1004 also called for big changes in the taxation regime, including a request for the Duma to reduce the number of taxes levied, and to impose a 10-20% decrease in corporate income tax.¹⁷⁸

¹⁷⁴ Commercial Department, British Embassy, Moscow, *Setting Up an Office in Moscow — A Guide for Business Representatives*, June 1992.

¹⁷⁵ BEE, 8 November 1993, p. 7.

¹⁷⁶ BEE, 6 June 1994, p. 2; and 18 July 1994, p. 2.

¹⁷⁷ *Ibid.*, p. 1.

¹⁷⁸ BEE, 20 June 1994, p. 7.

Despite this intention to reduce the number of taxes, in practice the new possibility for regions to impose their own taxes has meant an increase in the number of levies. For example, Moscow city has imposed three new taxes on all commercial enterprises, including joint ventures, as of 1 March 1994: i) a residential and social infrastructure tax, of 1.5% of companies' pre-tax profit; ii) an educational facilities' tax, of 1% of companies' payroll, and iii) a \$1 per day tourist tax, to be collected by hotels. The fact that the first of these taxes is on turnover suggests that they are separate from the share of profit tax which regions can also claim. In another example of how taxes appear to be worsening, the maximum rate for property tax was raised from 1% to 2% in mid-1994.¹⁷⁹ Many Western companies have also had to pay excess wages tax levied on salaries over six times the minimum wage (about \$60/month), although this was supposedly aimed at local wages. There has been confusion over the propriety of this practice; the State Tax Inspectorate has said that foreign companies do not have to pay the extra tax, whilst El'tsin has been quoted as saying that 'all' companies must pay it.¹⁸⁰ Thus the tax regime, although sometimes showing very promising signs of becoming less prohibitive and more stable, has on the whole remained a disincentive to invest, in part because of the high rate of taxation once the taxes are amalgamated, and in part because of the continuing unpredictability of levies.

In short, still by the end of 1994, there were very many serious problems which limited the number and size of investors ready to gamble on Russia, and a long way to go before the business environment in Russia could be seen as anything vaguely resembling that in the rest of Europe.

Other changes, however, have made the prospect of business involvement in Russia more attractive, apart from the increased convertibility and access to suppliers. One of these has been the increase in the number and size of funds which guarantee investments in Russia. Most of these are funded by Western

¹⁷⁹ *BEE*, 18 July 1994, p. 2, and 7 March 1994, p. 8.

¹⁸⁰ *BEE*, 6 June 1994, p. 1.

governments and can be considered as part of aid, and are therefore discussed in the following chapter. There is also a growing number of private investment funds involved in Russia. The Flemings Russia Investment Corporation Ltd (FRIC — see Appendix One for their involvement in the aeronautics industry), was the first such Western fund to be aimed purely at the USSR, established in 1991. This self-sponsored and self-managed fund, with \$15m in capital, invested mostly in new or privatized enterprises expected to earn hard currency, especially in aeronautics, and forestry/furniture.¹⁸¹ We have already seen that the CSFB have established a strong presence as the first Western bank to be dealing with portfolio investments on the Russian market, and they were joined in 1994 by Lehman Brothers (a \$300m Fund), Paine Webber (\$105m), and the Firebird Fund (\$40m).¹⁸² The Russian government also established a fund to protect foreign investors against political risk, called the State Investment Corporation (SIC), created by Presidential decree in February 1993. In the autumn of 1993, the Russian government deposited its first payment of \$100m in the SIC (in an unnamed West European bank), aiming ultimately to reach \$1bn.¹⁸³

Most of all, it is still the size of the Russian market, and its untapped opportunities, which keep attracting new investors. Encouraged also by the positive changes described above, entrepreneurs have established more and more joint ventures and wholly-owned subsidiaries, despite the time and bureaucracy involved. By July 1993, for example, there were 9,125 registered JVs with foreign capital in Russia, mainly involving partners from the USA (1,433), Germany (1,141), Britain (557), Italy (511) and Austria (475).

The level of foreign investment attracted into Russia up to 1995 undeniably leaves much to be desired when compared to most other former Communist states in Eastern Europe, or to China. The figures themselves are not very encouraging. Figures for FDI to Russia in 1994 vary, from \$1bn estimated

¹⁸¹ Interview with Mark V. Jarvis, FRIC Fund Manager, 21 May 1996; *BEE*, 18 April 1994, p. 3.

¹⁸² EIU, *Country Report — Russia*, London, 2nd quarter 1995, p. 33.

¹⁸³ *BEE*, 6 September 1993, p. 3.

by the EBRD¹⁸⁴ to an EIU estimate of around \$3.6bn.¹⁸⁵ If we use the figure given by the Russian Ministry of the Economy,¹⁸⁶ which is conveniently situated between the two figures quoted above, we get \$2bn in FDI to Russia in 1994. Using EBRD figures for Central and East European Countries, this Russian FDI figure is much higher than that for any of Moscow's former allies in 1994, with Hungary at \$1.15bn, the Czech Republic at \$0.85bn, Poland at \$0.54bn, Romania at \$0.43bn, and Slovakia at \$0.19bn (although in 1993 Russia's FDI was far behind Hungary's, and if EBRD figures are taken, even behind Poland, the Czech Republic and Kazakhstan).¹⁸⁷ In *per capita* terms, of course, Russia does not quite measure up to Central Europe. Whilst \$2bn received by Russia amounts to \$7 *per capita*, in 1994 Hungary received \$111 *per capita*, former Czechoslovakia \$69, and Poland \$14 per person.¹⁸⁸ If compared to China's FDI, foreign injections of capital into Russia appear to be even more modest — according to official figures produced in 1994, Russia was attracting only 4% of FDI directed towards China. The case of China is exceptional, however. A poll by Ernst and Young of companies which are internationally active showed that 58% of them had invested, or were planning to invest, in China, whilst this figure was only 6% for Russia, Poland and former Czechoslovakia (all other CEECs were lower still).¹⁸⁹

Even in the comparison with China, however, there are some positive aspects. Russia could simply not compete with some factors which have supported the growth of foreign investment in China, including the impressive interest rate of 30% of GDP between 1952 and 1975, whilst the ratio of foreign indebtedness was only 4% of GDP in 1980. Most important of all, 60% of the

184 EBRD, *Transition Report — 1995*, London, p. 87; this figure was obtained before all the relevant figures were available.

185 EIU, *Country Report — Russia*, London, 2nd quarter 1995, p. 33.

186 Government of the Russian Federation, *Russian Economic Trends*, op. cit., p. 117.

187 EBRD, *Transition Report — 1995*, London, p. 87; EBRD figures for 1993 FDI: Russia — \$400m; Poland — \$580m; Czech Republic — 517m; Kazakhstan — \$473m. Of all these figures, only Russia's and Czechia's increased in 1994.

188 Population figures as in Government of the Russian Federation, *Russian Economic Trends*, op. cit.

189 Government of the Russian Federation, *Russian Economic Trends*, op. cit., p. 117.

inflow of FDI into China came from Hong Kong Chinese, an advantage for which Russia cannot be seen at fault for not having. Martin Raiser believes that even in the medium term, China's overwhelming advantage in attracting foreign investment is likely to be greatly eroded. Central Europe, and to a large extent Russia as well, will reap the benefits of having gone through vigorous structural political as well as economic reforms, and of their highly educated labour forces. Raiser writes that

...as their continuing effectiveness comes under suspicion, China's policy makers may have to learn from their counterparts in EMEs (European emerging market economies) that changes in the behaviour of economic actors within the public sector may require more than changes at the margin.¹⁹⁰

When comparing Russia to Central European countries, the differences which have meant Russia receiving less FDI *per capita* are explained throughout this chapter, but can be summarized as follows: insufficient use of the period of 'extraordinary politics', allowing a much greater proportion of the old élite to remain in power; greater governmental incompetence and obstruction; much more gradual approach of reforms; and lack of information on companies, and of coordination between various bodies and levels of government.¹⁹¹ Russia's relatively unattractive position is quickly changing, however. As well as its privatization progress, which has always been exceptional, Russia's more recent successes in macroeconomic stabilization, currency stability and gradually increasing experience at dealing with foreign partners in an acceptable manner have all meant that Russia's attractiveness is growing. This is magnified by the fact that the lack of competition and the supernatural profits which existed in Central Europe have dwindled away, whilst they are still largely present in Russia. The EBRD confirms that foreign investment in the former CMEA is

190 Martin Raiser, 'Lessons for Whom, from Whom? The Transition from Socialism in China and Central Eastern Europe Compared', *Communist Economies and Economic Transformation*, vol. 7, no. 2, 1995, pp. 138 and 150.

191 Anders Åslund, 'Has Poland Been Useful as a Model for Russia?' in *Economic Transformation in Russia*, ed. Anders Åslund, London, 1994, pp. 157-73.

spreading out geographically. The dominance of the top five countries has eroded from 83% of total FDI in the region in 1992 to 68% in 1994.¹⁹² Evidence points to the conclusion that there is already a steady flow of foreign direct investment into Russia — although still low compared to Central European *per capita* figures — and this flow into Russia is likely to expand exponentially if the legal and political climates can become more stable and predictable.

In trying to estimate the amount of investment coming from the West, it must be remembered that figures for foreign direct investment usually reflect only financial investments, excluding the provision of equipment (unless included as a share capital contribution) and even of wages. There is a strong disincentive to include equipment or other expenditure investment in the share capital of a JV, in that buying equipment in exchange for production, rather than in exchange for equity, can reduce declared profits. Therefore, whilst the EIU estimate of FDI to Russia by the end of 1993 was of \$2bn,¹⁹³ already by April 1993 the level of investment purely in JVs was evaluated at \$7.6bn, representing 3.9% of total investment in the country's economy.¹⁹⁴ The amount of foreign investment overall is clearly considerably higher than the figure for FDI. According to the consultancy firm Pete Marwick, there was approximately \$6bn of Western investment injected into Russia in 1993.¹⁹⁵ The table of some major investment projects in Russia (Table 3.1), including only the projects with a total planned investment of over \$150m which had been made public by the autumn of 1994, shows that the levels of commitment are high, even if immediate disbursing of capital is still relatively limited. As noted in the section on privatization, Western portfolio investment is also now expected to grow rapidly with post-voucher privatization. According to the Head of the Russian Privatization Centre Maksim

¹⁹² EBRD, *Transition Report — 1995*, London, p. 86.

¹⁹³ EIU, *Country Report — Russia*, London, 2nd quarter 1994, p. 23.

¹⁹⁴ BEE, 4 October 1993, p. 3.

¹⁹⁵ Richard Layard, 'Can Russia Make It?', lecture given at the London School of Economics and Political Science, University of London, 8 February 1994.

Boiko, from March to May 1994 \$1bn of equity had flowed into Russia, as against virtually none the year before.¹⁹⁶

Apart from the energy sector (see Appendix Two), the areas attracting the most investment were telecommunications, automobile production, food and drink production, cigarette production and forestry. A selection of some of the projects involving European enterprises follows.

Despite the very large amounts of investment involved in telecommunication projects, and the slow rate of return, this sector has been second only to energy projects in the volume of investment commitments it has attracted. This sector also reflects the benefits of the CoCom trade restrictions having been lifted. The most important project is by a Deutsche Telekom-led consortium, which has concluded a memorandum of understanding with the local enterprise Intertelekom on a \$1bn project to modernize the country's telecommunication infrastructure. The plan is to build 50,000km of glass fibre cables and install a digital network connecting some fifty Russian cities with some fifty West European cities; the Western consortium's investment will be of \$600m. In a much smaller project, the British firm Cable & Wireless have offered \$40m worth of services to Petersburg Long Distance, involving a 25.1% acquisition of this Russia-Kazakhstan JV.¹⁹⁷ Without this input, Russia could not be expected to participate in the international 'information superhighway', and could not supply essential fax and electronic mail services to either foreign or local potential investors. This is of particular importance for the development of non-metropolitan Russia.

In automobile production the German company Mercedes-Benz, encouraged by very high sales of its vehicles in Russia (over \$250m in 1993), signed a letter of intent with the local Uljanovsk Automobile Works (AvtoUAZ) for the joint production of Land Rover-type vehicles, and has also agreed to

¹⁹⁶ 'Russian Privatisation — Briefing Held by Sir Leon Brittan and Maxim Boycko, Head of the Russian Privatisation Centre', document issued by the European Commission's London Delegation, 5 June 1994, p. 2

¹⁹⁷ *BEE*, 16 August 1993, p. 11, and 18 July 1994, p. 10.

cooperate with Avtrokon, a Russian bus manufacturer, to assemble up to 2,500 buses *p.a.*¹⁹⁸ Volvo Bussar (the bus division of Volvo) also plans to build buses in Russia, starting in 1994, on the basis of chassis imported from Sweden.¹⁹⁹ This type of investment is crucial, and needs to be increased substantially, if Russia is to have a chance at avoiding its automobile industry being entirely destroyed by imports.

In the food industry, one of the larger projects is being carried out by Master Foods of Austria, which has obtained permission from the Moscow authorities to build a \$100m production facility for 'Uncle Ben's' sauces, ice-cream, confectionary products and pet foods, with production expected to begin in 1995.²⁰⁰ The Russian *penchant* for ice-cream has already been exploited by the British Allied Lyons group, who in 1992 started building a \$45m ice-cream plant through the Baskin-Robbins JV with the Russian Ministry of Trade's Rosmiastoltorg.²⁰¹ In the tobacco industry, two British enterprises are involved in the largest investments, BAT industries developing a factory in Saratov needing \$40m in capital, whilst Rothmans International has committed itself to a cigarette-producing factory involving an investment of \$36m.²⁰²

These projects can be seen as merely the cutting edge, the toe of Western capital testing the water, and if political, legislative and fiscal stability can be used to achieve the right temperature, very many EU investors can be expected to dive in, increasing the interdependence between Russian and the EU still further.

¹⁹⁸ *BEE*, 22 November 1993, p. 9, and 20 September 1993, p. 9.

¹⁹⁹ *BEE*, 15 November 1993, p. 9.

²⁰⁰ *BEE*, 4 April 1994, p. 10.

²⁰¹ *The Guardian*, 16 April 1992.

²⁰² *BEE*, 18 July 1994, p. 10.

3.8 Conclusions

It is clear that, especially considering the terrible economic inheritance of the Soviet Union, Russia has gone a long way indeed towards making itself attractive to EU investors, and open to Western goods.

The progress towards the level of openness and compatibility achieved by the end of 1994 was certainly not without its hold-ups and mistakes. Gorbachev achieved a great deal, but still left El'tsin with a soft currency, a huge inflationary overhang, a process of privatization which had barely begun, a shortage economy, and very restrictive legislation with regard to Western investors. Russia's first President largely solved these problems, but by 1995 had still to achieve much before EU investors and even exporters and importers were ready to risk much more in Russia. Perhaps the greatest disincentive, and probably the most difficult to solve, was the political instability which resulted from the discontentment of the dispossessed groups (pensioners, soldiers, Party cadres), and a lack of control over, and coordination with, regional and city authorities. This is linked to the other great factor alienating Western investment, namely the ambiguous, changeable and badly enforced legislation. One particular arm of legislation, relating to tax liability, is particularly to blame. The unpredictability and prohibitiveness of the fiscal system has continued to prevent both foreigners and potential Russian partners from either increasing their levels of production, or from producing at all. Another significant barrier to foreign economic involvement in Russia which El'tsin still had to overcome was organized crime, and its protection by politicians. It has become increasingly clear that the authorities at every level are half-hearted at best in their attempts to combat organized crime. The debt crisis, both that of the whole country *vis-à-vis* foreign governmental and private creditors, and that between Russian enterprises themselves, and the lack of cash created by this crisis, are also a considerable

hinderance. Finally, the lack of infrastructure, in everything from telephone lines which can support faxes and electronic mail to hotels without cockroaches and which can be reserved from abroad, are all contributing to keeping EU business people away.

Nevertheless, despite such an overwhelming catalogue of disincentives, EU and other investors and traders have kept dealing with Russia, for ever greater amounts. Gorbachev began to pave the way for them by de-monopolizing foreign trade, by making the use of hard currency in Russia legal, by allowing foreign involvement in JVs, and starting the privatization process, on top of all the politically attractive actions described in Chapter One. Gorbachev's task was all the more impressive considering the lack of precedents for such actions under Soviet rule; his contribution should be seen as the turning point, which made all further progress in opening up the Russian economy to Western Europe possible. The inefficiency and lack of innovation inherent in the command economy which Gorbachev inherited made this opening up to the West particularly unavoidable, as Soviet technology fell further and further behind that of the rest of the world. El'tsin followed by pushing hard for a privatization process which was faster and more extensive than in any other former CMEA country, and by allowing Westerners to invest in Russian shares, once voucher privatization was over. Boris Nikolaevich achieved full internal convertibility, and by freeing prices despite the political cost, he managed to achieve commodity convertibility as well, whilst absorbing the inflationary overhang, despite the inflationary cost. Of even more direct relevance to EU business people, full repatriation of profits was legalized. The importance of these changes is tremendous.

The fact that the macroeconomic situation has stabilized sufficiently for the IMF to continue supporting Russia — as shown again by the \$6.8bn stabilization fund for Russia which was approved in early 1995 (see Chapter Four) — has helped give confidence to potential Western investors. Although having a certain dampening effect upon EU exporters, the increase of some import taxes and the disappearance of import subsidies has been an extra

motivating factor for EU companies considering production in Russia. Also helpful is the constant improvement in banking relations between Russian and EU banks, increasing dealing with everything from ATMs to large letters of credit, this of course encouraging both investors and traders.

It is for all these reasons that the number of joint ventures has continued to increase, not only in theory, but in the visibility of their products and of the effect of their competition and work ethics. Foreign Direct Investment into Russia has also continued to grow, to the point where it was bigger in size in 1994 than that of any Central European state, and approaching the size of Central European FDI *per capita*. This trend seems to be set now, as the attractiveness of Central Europe fades just as its normality increases, and the wave of European FDI moves eastwards and southwards.

Despite the lack of reliability of Soviet GDP and export/import figures, it is still obvious that the USSR's trade with the rest of the world was relatively small, but its importance disproportionately great, as the goods being imported were of strategic importance, needed to solve bottle-necks or technological inadequacy of Soviet equipment. Although overall (officially registered) trade with the rest of the world decreased in the first three years of the 1990s, and only picked up slightly in 1994, trade with the EU *per se* has increased overall by more than 45% between 1989 and 1994.²⁰³ It should be stressed that in this 'shuttle' trade is included. Despite the fact that a large part of this increase is from consumer goods and food products, Russian industry is more dependent than ever on Western technology, as investment in R&D in purely Russian projects is lower than ever. Both in terms of equipment, and of capital — in fact also in know-how — Russia can ill afford to become isolated from the EU and the rest of the capitalist world, lest it fall much further behind in technological terms, whilst the rest of the world develops ever faster.

203 *Towards Greater Economic Integration — The European Union's Financial Assistance and Trade Policy for Central and Eastern Europe and the New Independent States*, European Commission, DG 1A, Brussels, October 1995, p. 15 — here also, the same mid-1994 Ecu:Dollar rate is used.

In a nutshell, at the end of 1994 the Russian market is much more open to Western investors and traders than it ever has been, and the commercial interdependence between Russia and the EU is also as high as ever. Having said that, still much needs to be done to make this potential develop into the actual boom which Russia needs to pull itself out of the economic rut it is in. For the EU business community, most of all, there is a need to prove the longevity and enforceability of the new economic laws, to make the taxation regime simpler and less prohibitive, and to develop a more effective and user-friendly system of government, at Federal, regional and local level. These are but some of the areas in which assistance from the West could play an important role, helping to increase the level of economic interaction between Russia and the European Union.

TABLE 3.1: MAJOR WESTERN INVESTMENT PROJECTS IN RUSSIA

Western Partner(s)	Russian Partner(s)	Project Site	West./Total Investment	Type of Project
Wintershall Gas (Ger.)	Gazprom	Iamal to Germany	? / \$40bn (in 25 yrs.)	Chosen to participate in building of planned Iamal-Evropa pipeline (one of many companies chose).
Marathon/McDermott/Mitsubishi/Mitsui/Shell	not yet clear	Sakhalin-2	? / \$10bn (310m in 1st 5 yrs)	Oil and gas extraction and export.
Exxon/Sodeco (US&Jap.)	?	Sakhalin-1	? / \$10bn	Oil and gas extraction and export.
ENI/Nuovo Pignone (I)	Gazprom	nation-wide	\$2bn (contract)	Funding of \$1.6bn by It. & UN banks.
Ekman Liebig (Swe)	Bratskii	Bratsk	? / \$2bn	Joint exporting of wood, wood pulp and paper, and upgrading of production.
ABB Lummus Crest (US)	Lukoil	Krasnodar	? / \$1.5bn	Development of refinery.
General Atomics (US)	Rus. Min. of Atomic Energy	?	? / \$1.5bn	JV, to build a nuclear reactor.
Deutsche Telekom-led consortium	Intertelekom	50 Rus. cities	\$600m / \$1bn	Lay 50,000km of glass fibre cables; set up a digital network with West
GM (US)	AvtoVAZ	Togliatti	\$700m (contract)	To fit cars with fuel injection systems.
Mitsui (Jap.)	Lukoil	?	\$700m / ?	Project to boost oil yields.

Western Partner(s)	Russian Partner(s)	Project Site	West./Total Investment	Type of Project
Treuhand (Ger.)	Tiumen' oblast' government	Tiumen'	\$645m (credit)	For imports of German oil equipment.
Lucky Goldstar Intl. (S. Korea)	Sakha rep. govt.	Sakha republic	? / \$600m	Development of the Elga coal mine.
Treuhand & a Dresdner Bank-led consortium	Perm oblast' govt.	Perm	\$515m (barter credit)	For purchase of East German mining eqpmt, machine tools etc.
ABB Lummus Crest/Chevron (US)	Kirishi refinery	110km from SPb.	? / \$500m	Provide 'isocracking' tech. to refinery.
KWU (Ger.), IVO Intl. & Polar Corp. (Fin.)	FTO Technopromexport	St Petersburg	\$385m / ?	To build a cogeneration plant.
SIBG (Ger.)	KamAZ	Tatarstan	\$340m / \$440m	Producing lorry transmissions.
US West	none	Moscow	\$275m (estim. min.)	Telecomms. projects, incl. fibre-optics.
Partner für Fahrzeug Ausstattungen (Ger.)	Russian state train company	?	\$260-385m (contract) passenger wagons.	Modernization of 400 railway passenger wagons.
P&W (US) and MTU (Ger)	Perm Motors and the Aviadvigatel' bureau	Perm	\$250m / ?	Design, build, test and market aero-engines.
Sumito, NEC (Jap.), Siemens (Ger.) & co.	Intertelekom	Moscow to Khabarovsk	\$250m (contract)	Set up a telecommunications network between Moscow and Khabarovsk.

Western Partner(s)	Russian Partner(s)	Project Site	West./Total Investment	Type of Project
Star Mining (Australia)	Irkutsk govt.	Irkutsk region	\$250m (in 6 years) / ?	Increase productivity of gold mine.
Tecnimont (Italy)	?	Ufa	\$200 (contract)	To build 3 turnkey chemical plants.
SMS-led group (Ger.)	MMK	Magnitogorsk	\$190m / \$645m	Contract to help build a steel plant.
Acma (Sing.)	?	22 Russian regions	\$160m (contract)	Provision of microwave communication equipment.
Mabetex (Switz.)	?	Iakutsk	\$150m (contract)	To build a maternity hospital.
BNP (Fr.)	AvtoVAZ	Togliatti	\$150m (loan)	For production of new car model.

N.B. — Many of these projects were still at the feasibility study phase at the time of writing, and the investments involved were mainly contemplated over periods exceeding five years.

Sources: Various sources cited in Chapter three and Appendices one and two.

Chapter 4: Western Aid and Economic Assistance to Russia

4.1 Introduction

This chapter aims to uncover what the European Union can achieve through assistance to Russia. In order to do this, we shall firstly explore the nature of Western statecraft towards the USSR/Russia since the October Revolution, how it has changed, and why a further increase in positive statecraft is being resisted. The role of Western Europe, and the often contrasting approach of the USA, is examined in order to show the relatively privileged position of the EC/EU as a more open trading partner and more generous donor to Russia.

The enormous impact of Gorbachev's and El'tsin's reforms on Western assistance to the USSR/Russia is noted, as are the various Western responses to the new conditions. The various aid plans which were put forward are covered, as are the reasons why they were mostly not carried out, or were much less generous than claimed.

The EC/EU's own aid to the USSR/Russia is then explored in detail, to determine which aspects of it can be expected to contribute effectively to the success of reforms and/or the development of closer relations with the EU, and which aspects can further fuel criticism of Western aid to Russia and its motives. The EU's gradually increasing cooperation with other bodies, and in particular the EBRD, is examined, as is the important potential for Brussels to improve the still inadequate coordination of aid between the Union, the IFIs, and individual donor countries.

4.2 The Changing Approaches of Western Economic Statecraft Towards Russia

Definition of 'Statecraft', and the First Aid Programmes to Soviet Russia

Since the late 1980s, the granting of assistance to the Soviet Union, and later to its successor states, has become a focal point of relations between the West and the ex-USSR, and one in which the EC/EU has played a particularly important role. Although the granting of aid to the USSR would have been considered a nonsense between the end of the Second World War and *perestroika*, the question of how the West should use its economic policies to encourage desired developments in Russia is an old one indeed: such attempts to influence other countries' actions are known as economic statecraft. To better understand what the EU can expect to achieve from granting various types of aid to Russia, we can learn much from looking at the theoretical debates over using aid to improve relations with the USSR/Russia, and the successes and failures of past attempts at using statecraft with Moscow.

Different writers use different meanings of the term 'economic statecraft', so a precise definition is essential. David Baldwin described statecraft as 'all of the economic means by which foreign policy actors might try to influence the political situation, either domestic or foreign, of other international actors',¹ and this is the definition used in this thesis. It is often useful to contrast separate statecraft from 'pure aid', which is a much rarer occurrence. Aid in its 'purest' form occurs when it is given exclusively to stop human suffering, in other words where the donor country simply exercises benevolence, or appeases its guilt, depending on the point of view. Such aid is not even an exercise attempting to avoid a flow of refugees into the donor country, nor foreseeing the possibility of

¹ Based on the definition used by David Baldwin in his 1985 book *Economic Statecraft*; cited from Philip Hanson, op. cit... p.6.

civil war in the recipient country spilling over and affecting the donor country, or its sources of materials or profit. Any political change resulting from such 'pure aid'² is incidental; the aim having been to 'do good'. Food aid to Third World countries is the most common variant of 'pure aid', although it by no means always qualifies, often entailing conditions or ulterior motives. Such 'pure aid' has only very uncommonly been directed to Russia. This is not least because in terms of physical suffering and risk of fatal malnutrition or diseases, the needs of many Third World countries are much greater. Such selfless aid did spontaneously emerge, in particular in the autumn of 1990, when there were widespread fears of starvation in the Soviet Union in the winter to come; many non-governmental organizations (NGOs), especially in Germany, responded with food donations and the required transport. All in all, however, the projects for aid and assistance to the FSU tend to be offered with different expectations.

Even the first example of significant Western aid to Soviet Russia (disregarding loans during the First World War), The American Famine Relief Programmes of 1921-23, had important elements of statecraft. The widespread famine in Russia in 1921-22, following drought and economic chaos due to the lack of any motivation for farmers to grow more than they needed for themselves, had led to Maksim Gorkii's plea to the United States for help. Although the United States had had no diplomatic relations with Russia³ since 1917, Secretary of Commerce Herbert Hoover convinced the Harding administration to carry this initiative through, under the auspices of the American Relief Administration

² This is a much narrower definition than the one given by Baldwin (*op. cit.*, p. 294), in other words where 'there is no payment, either in money or in support for the donor's foreign policy': quoted from Peter van Ham, 1992, *op. cit.*, p. 59.

³ It is pertinent also to note that one of the main issues preventing the US from re-establishing relations with Russia was that of debt-claims, which the Americans estimated at \$636m. for loans extended during the First World War, and for property confiscated during the Bolshevik revolution. Even when, in 1933, Roosevelt initiated meetings to re-establish diplomatic relations, the Commissar for Foreign Relations Maxim Litvinov anticipated El'tsin (although Boris Nikolaevich did not carry out his threat) by sixty years by claiming that most of the debts had been incurred by the previous (in other words tsarist and provisional) governments, and would thus not be refunded. The Soviet Union was finally recognized without the issue being resolved — see T. G. Paterson; J. G. Clifford and K. J. Hagan, 1988, third edition, Lexington; pp. 303-05.

(ARA) of which he was head.⁴ Hoover's support for such aid was based on the belief (later reversed) that 'Russian relief would contribute to the downfall of the Bolshevik regime': he had remarked to his Secretary of State that 'the relief measures will build a situation which, combined with other factors, will enable the Americans to undertake the leadership in the reconstruction of Russia when the proper moment arrives'.⁵ Partly because the Russian authorities were insulted by the conditions which the Americans had asked for (including the release of American prisoners in Russian prisons, a guarantee that aid workers would be housed and not interfered with, and that Russia officially acknowledge that the aid was wanted and needed), suspicions ran as high as ever. The aid nonetheless finally came through as the need became overwhelming, with some estimates of as many as ten million Soviet citizens having been saved from starvation as a result. Despite the official messages of gratefulness and of a new era of cooperation, however, no concrete signs of this were to become apparent in subsequent Soviet foreign policy.

Hoover's approach to statecraft had therefore been for the use of the carrot rather than the stick, for aid rather than sanctions. In this case the aid was real, but even talk about aid, a mere proposal for assistance, may constitute statecraft, as the threat of reducing or abandoning the project can then be used as a lever.

In the study of different approaches to aid, Functionalism and Strategism (Realism) can be used as two extremes of a scale. The true Strategists see the (former) Soviet Union as a snake, likely to bite the hand that feeds it, whilst the Functionalists see it as a wounded bear, which will become benign if cared for and helped to heal. Whilst the typical Functionalist approach is constructed upon the assumption that conflict is based on misunderstanding and fear that can be ironed out, the Strategic approach is based on the premise that the world is characterized by conflicts which can only be checked by force; in other words, it is the the school of economic interdependence versus that of economic

⁴ John Lewis Gaddis, *Russia, the Soviet Union, and the United States: An Interpretive History. American Foreign Policy. A History — since 1900*, New York, 1978, pp. 98-102.

⁵ Peter van Ham, 1992, op. cit., p. 60.

containment.⁶ As explained previously, both positions are extremes: few individuals or governments will be all one or all the other, and any period of time will see both schools in operation, though one of the two alternately tends to predominate.

The only other important example of pre-*perestroika* Western aid to the Soviets, the American 'lend-lease' programme during the Second World War, provides an interesting example of interaction between the two approaches. The granting of enormous amounts of civilian and military aid to assist the Soviet Union in its struggle against the Nazis was not being strongly opposed by either side in 1941, but the terms and conditions were contentious. The position supported by Franklin D Roosevelt was that the aid could be given without any conditions, as both sides were so dependent upon each other, and the Soviet Union's mere presence in the war was all that really mattered. It is likely that at the back of Roosevelt's mind was also the fear of a repetition of the First World War agreement between Moscow and Berlin. Although the Soviet Union had been despised in the West for its treaties with Nazi Germany as well as for attacking Finland, once it entered the war pragmatism had to prevail. The Democratic Representative Clifton Woodrum, during one of the debates on the lend-lease issue, best expressed the situation by using the proverb 'it is permitted to walk with the devil until the bridge is crossed'.⁷ Roosevelt's ambitions went further, however; he was counting on lend-lease to be of use after the war as well. Roosevelt had said about Stalin 'I think if I give him everything I possibly can and ask for nothing in return, *noblesse oblige*, he won't try to annex anything and will work with me for a world order of democracy and peace'.⁸

Meanwhile, US General Standley was one of the leading proponents of a more conditional approach. At the very least, he wanted to insist on the Soviet government publicizing this aid and its origin to its population. Standley warned Roosevelt that his plan was based on all the wrong assumptions about the Soviets;

⁶ Peter van Ham, 1993. op. cit., pp. 6-8.

⁷ George C. Herring Junior, *Aid to Russia — 1941-46*. New York, 1973. p. 22.

⁸ Peter van Ham, 1992. op. cit., p. 65.

US Ambassador to Moscow Averell Harriman agreed, and said that the US policy would be construed as a sign of weakness, and acceptance of Soviet policy.⁹ Roosevelt's successor in the White House, Harry Truman, brought with him a very different approach to lend-lease. This has been judged to have been partly owing to his natural Strategist tendency, but largely because by this time victory against the Nazis was clearly nearing, and after Ialta Stalin's determination to control Eastern Europe had also become more obvious. Even before the war in Europe was over, Truman sharply curtailed the lend-lease shipments to the Soviet Union.¹⁰ Stalin was furious, stating to US delegate Hopkins that he considered this course of action threatening and treacherous. Such was the acrimonious end to any hopes that the lend-lease programme would bear post-war fruit.

Both the 1921-23 food aid and the Second World War lend-lease achieved their main objectives: the ARA saving perhaps millions from starvation, whilst lend-lease played a significant role in the defeat of Nazi Germany. In both cases, however, the Functionalist hopes of coaxing the Russians to be more open and cooperative failed. Some drew the conclusion that only forceful methods are understood by the Russians, that they would only ever cooperate if compelled. It would be fairer to the Functionalists, however, to stress that in the case of the famine relief, the ideology of the revolution was still very fresh, as, more importantly, was the memory of American intervention during the Civil War, with American troops present in Siberia as late as April 1920. Although this did not prevent Lenin from wanting to trade for American technology, even at the price of leasing Kamchatka or Sakhalin if only the Americans would get the Japanese out,¹¹ it still meant that trust and good-will were to play no role. Concerning the

⁹ Ibid., pp. 58-66.

¹⁰ Herring Junior, *op. cit.*, pp. 280-88.

¹¹ First in October 1920, the Soviet government announced that it had granted exclusive rights on coal, oil and fishing for sixty years on approximately one million square kilometres of northeastern Siberia (including the whole of the Kamchatka peninsula) to an American syndicate led by Washington B. Vanderlip (who had been mistaken for the 'billionaire' Frank A. Vanderlip, and who in fact had no close links to the White House), land which was then under Japanese control. Once this came to nothing, oil magnate Harry F. Sinclair was granted a contract with the Far Eastern Republic (soon to be absorbed into the RSFSR) for the exploitation of oil on the northern half of Sakhalin, also under Japanese control. As even Sinclair's genuine contacts within the Harding administration failed to get the US

lend-lease. Stalin's own narrow-mindedness and paranoia must override any conclusions about general reactions of Russians to aid.

Nonetheless, as the same factors which minimized the long-term benefits from assistance to Soviet Russia led to diplomatic confrontation in Europe and alienation from the world economy, Strategists were to have a clear upper hand in Western debates on statecraft towards the USSR in the ensuing Cold War. The relevant question during the Cold War was not 'how much aid?', but 'how tight an embargo?'.

From Cold War to Détente, or from Stick to Carrot

As relations between the Soviet Union and the West took a sharp turn for the worse after 1946, the United States was particularly determined not to worsen the now considerable military threat from the USSR. A unilateral policy of export control was not sufficient, especially as a great deal of sophisticated American technology was being shipped to Western Europe through the European Recovery Programme. Thus, in November 1949 the Coordinating Committee for Multilateral Export Controls, or CoCom for short, was officially established. This was the first time that North America and Western Europe had formed a body specifically to prevent trade to a particular country and its allies, i.e. to perform 'negative' statecraft. From the beginning, however, consensus was hard to reach. The whole venture was clearly an American initiative, and the British and French in particular resented being told how to go about their foreign trade by the US. The so-called Battle Act of 1951, which legally linked American aid to submission to CoCom export restrictions (including goods without possible military application), did nothing to ameliorate diplomatic relations. CoCom itself, however, remained a guideline organization, not legally binding. Although

involved against Japan, the concession was eventually given to the occupiers: from John Lewis Gaddis, *op. cit.*, pp. 91-93.

compromise was reached on a list of restricted exports. disagreements over the definition of 'Strategic goods' which should be controlled by CoCom were to be an issue of contention for a long time to come.

'Strategic goods' can mean anything. When sold to a potential enemy, any commodity whatsoever can be either directly used by that country's military, or indirectly help by freeing part of the civilian industry to concentrate on military production. Once the threat of war is minimized, at least in the short and middle terms, the definition becomes narrower. Peter Wiles has discerned two main types of strategic goods: bottleneck items, without which the whole supply chain of the target nation is interrupted and the lack of which will be multiplied, to mean a much greater reduction in output than the value of the reduction in input; secondly, imported technology, even for civilian use, as its removal can increase the time lag before the target economy can catch up with the sanctioning country's technological level.¹² This definition has a strong Strategist flavour, though, and West Europeans have consistently argued for controls only over goods which have more direct military applications; thus even during the Cold War, Europeans had repeatedly put pressure for CoCom's industrial list ('List II', or 'List IB' in the US) to be strongly curtailed, or abandoned altogether. The discrepancy between the European and American approaches will be examined later on.

Together with the general political *détente* of the late 1960s came a revision of the approach to statecraft. The growth of a more Functionalist approach during this period had two main causes; i) the effect of the technological revolution, whereby communications transformed the Earth into a 'global village', and nuclear weapons brought military power too dangerous to use, therefore other factors had to prevail in international relations; cooperation was now vital for survival; ii) both populations and governments had had enough of confrontation

¹² Philip Hanson, op. cit., p. 10.

and of the tense international situation: the Cold War mentality had outlived its natural life.¹³

The change in approach to statecraft varied in speed on either side of the Atlantic, however. Serious disagreements occurred in 1978 amongst Western allies, when President Carter's sanctions (on human rights' grounds) on sales of oil and gas drilling equipment were not backed by the major EC countries. Following the establishment of martial law in Poland, a new round of US sanctions was enacted, against both Poland and the USSR. US sanctions against the USSR were to cover equipment, produced under US licence by West European firms, for the compressor stations of the Urengoi/Western Europe gas pipeline. This time Western Europe, and West Germany in particular, felt that too much was at stake and refused to comply. The Americans finally agreed to the compressor-equipment deals going ahead, and to Western Europe receiving important amounts of Soviet gas (although this was to be limited to a maximum of 35% of total gas usage of any US ally).¹⁴

The situation was thus not very different from the early days of CoCom, when *The Economist* summed up Western Europe's attitude, and particularly that of Britain and France, when it remarked that,

the Battle Bill implies either that America's allies are disloyal or that they are incapable of deciding for themselves what is the balance of gain and loss in their exchanges with the Communist countries — in short, that they are either fools or rascals.¹⁵

In the United States, however, very strong anti-trade statements continued to come from the highest quarters. Secretary of Defence Caspar Weinberger, for example, declared in 1982:

Without constant infusion of advanced technology from the West, the Soviet industrial base would experience a cumulative obsolescence, which would eventually constrain the military industries — without access to advanced technology from the

¹³ Peter van Ham 1992. op.cit., pp. 26-27.

¹⁴ Philip Hanson, op. cit., p. 46.

¹⁵ *The Economist*, 25 August 1951. pp. 431-33.

West, the Soviet leadership would be forced to choose between its military-industrial priorities and the preservation of a tightly-controlled political system. By allowing access to a wide range of advanced technologies, we enable the Soviet leadership to evade that dilemma.¹⁶

Sovietologist and former member of the National Security Council Richard Pipes put it in simpler terms: 'The Soviet Union is one great war machine [...] Thus, Western energy assistance helps the USSR to build up its military [...]'.¹⁷ This was all part of the philosophy behind the USA's declared attempt to make the USSR 'arm itself to death'. It was for such reasons that in 1987, the USA was the only OECD country to deny the USSR MFN status.¹⁸

The above description of the American policy on statecraft to the USSR (until the late 1980s) is provided as a contrast, to put the approach chosen by the EC countries into perspective. There is no one simple reason why Western Europe's approach has tended to differ. Some analysts have underestimated the many implications of West European proximity to the Soviet superpower. The short distances meant that trade was much more difficult to prevent between Europe's East and West. As mentioned previously, improvements in communication, relative reductions in the costs of transport, and decreasing size of many components of advanced technology all made trade restrictions more difficult to enforce, and West Europeans were more realistic about the impossibility of the total isolation of Eastern Europe. It is also true that a greater proportion of West European jobs and profits were linked to trade with the Eastern Bloc, making trade restriction a more politically difficult option for Western Europe than for the USA. What trade the Americans did have with the USSR was not in technology; in the early 1980s, 80% of American exports to the Eastern Bloc consisted of grain.¹⁹ and the American abandonment of the grain

¹⁶ *The Economist*, 22 May 1982, p. 67.

¹⁷ Cited from Philip Hanson, *op. cit.*, p. 54.

¹⁸ *Ibid.*, p. 57.

¹⁹ *The Economist*, 22 May 1982, p. 63.

embargo was a decisive factor in strengthening the resolve of Europeans to defeat the oil equipment embargo.

Whether because of these reasons, or due to a different intellectual approach, or of 'instinctive' pan-European understanding, Western Europe's perception of the factors which justified an embargo towards the USSR differed greatly from that prevalent amongst the decision-makers of the United States. All of the following premises were, on the whole, considered to be much less important by West Europeans than by Americans: the scope of the Western embargo; the probability of war; the level of Soviet aggressiveness; the level of Soviet dependence upon East-West trade; the technology gap between East and West.²⁰

It must be remembered, however, that such generalizations concerning American and European attitudes hide important differences that existed between various sectors of the respective societies. For example, European NATO defence ministers tended to have a similar viewpoint to that of the US Defence Department, whilst on the other hand there were bitter debates between departments of the US government which defended the interest of American exporters, and the defence establishment.²¹

Gorbachev and the Metamorphosis of Statecraft

All the above definitions and approaches were worked out in the pre-Gorbachev era. The very foundations upon which the Functionalist and Strategist positions had been formed were altered in the second half of the 1980s. First with *perestroika*, then with the August 1991 popular counter-coup followed by El'tsin's attempts to implement democratic reforms, even the staunchest Russophobes had to re-evaluate the probability of Russian aggression against the

²⁰ Peter van Ham. 1992. op. cit., p. 159.

²¹ Philip Hanson. 1988. op. cit., p. 3.

West. By the beginning of the 1990s, the most popular view on trade with the Soviet Union was the opposite to that of the Cold War — not only was trade with the East not seen as increasing the threat, but failure to increase it came to be perceived as the greatest danger. This emergence of a more pro-trade attitude was partly due to old arguments. Functionalists had always argued that even if the West should want to control Russia's actions, 'negative' statecraft, that is sanctions and embargoes, were by their very nature decreasingly efficient, as they forced the Soviets to find ways of becoming self-sufficient; on the other hand, 'positive' statecraft was intrinsically and increasingly effective, as with it increased dependency, and therefore Western leverage on Russian policies. More positively, pro-traders counted on a 'habit of cooperation' to form, which would be diffused from the economic into the political sphere, contrarily to isolation which led to ignorance and fear of the other side. As we have seen in chapter two, the late 1980s also brought a realization of the need for pan-European cooperation in the fields of ecology and nuclear power.

Most important of all has been the fear that the pro-market and democratic reforms could fail if popular support is not encouraged through a tangible improvement in Russia of the material standard of living. The possibility of the unstable political situation reverting to large-scale civil war, and/or an authoritarian/populist takeover, has been the main motivation for Western plans to provide various types of aid and assistance.

After the previous decades of adversity and withdrawal, the new level of enthusiasm for cooperation was startling. This mood even went as far as proposals for a 'Marshall Plan' for Eastern Europe, forwarded as early as the spring of 1988 by the Italian industrialist Carlo de Benedetti, and later endorsed by former French President Giscard d'Estaing, as well as by an editorial in *Le Monde*. The latter called for measures towards the USSR which would 'increase the weight of Europe in the world, whilst also alleviating the fate of a whole

sector of its population'.²² During the following years, such calls were repeated from very varied sources, but although many of the more concrete proposals for aid were very important in scale, none of the seriously considered projects have come close to the levels of commitment and support of the European Recovery Programme. According to one estimate, at today's prices the Marshall Plan was worth \$300bn a year.²³ whilst between September 1990 and late May 1992 the West had pledged a relatively tiny \$70bn to the FSU.²⁴ Another difference is the lag, both in volume and in timing, between the pledges and actual disbursements. Only 13bnECU of the 62bnECU committed by January 1992 had been received by the former USSR by the end of spring 1992.²⁵ By far the most obvious sign that the level of aid in the 1990s is incomparably less than aid given after the war is the fact that most of the Marshall Plan consisted of grants, whilst the vast majority of present pledges are credits or loans.²⁶

Nonetheless, there have been some momentous plans to rejuvenate and rationalize the Soviet economy. The most popular of these during Gorbachev's time in power was the so-called 'Grand Bargain' or 'Harvard Plan', devised mainly by Graham Allison and Grigori Iavlinskii. They concentrated on adapting the Soviet economy to the 'six recognised pillars of the world economy': stabilization of the macroeconomy; liberation of prices; establishment of and respect for private property, ownership and enforceable contracts; privatization of enterprise; opening of the economy to normal international trade; and limiting direct governmental intervention in the market.²⁷ This was definitely not a pure gift of goodwill; there was a reforming price to pay for the assistance. Martin Walker described the Grand Bargain as 'the plan to exchange financial aid in return for Soviet structural and economic reform'. Neither was it ever meant to

²² 'Élargir le poids de l'Europe dans le monde, tout en allégeant le sort de toute une partie de la population', in Neil Malcolm, 1989, op. cit., p.5; from *Le Monde*, 29 March 1988.

²³ Victor Keegan in *The Guardian*, 3 June 1991.

²⁴ Perdita Fraser, *The Post-Soviet States and the European Community*, London, 1992, p. 42.

²⁵ *Ibid.*, p. 35.

²⁶ Philip Hanson, 'Western Aid to the Soviet Union's Successor States', *RFE/RL Research Report*, vol. 1, no. 18, 1 May 1992.

²⁷ Graham Allison and Grigoriy Yavlinsky, *Window of Opportunity: Transforming the Soviet Union into a Democracy with a Market Economy*, 19 June 1991, p. 4.

be easy: estimates of the unemployment that would be caused by the Harvard Plan were of a minimum of 11 million people, possibly twice that amount.²⁸ The reward to be received from the West was sizable, in the order of \$25-30bn per year for three to five years.

Back in mid-1991, however, when the Grand Bargain was most fervently being discussed, the industrialized nations were not willing to fund any grand schemes. In comparing it to the post-war aid, many critics pointed out that contrarily to Germany in the late 1940s, the Soviet Union at the end of the 1980s was not starting from scratch; it was argued that any massive aid would simply be grafted onto a rotten system.²⁹ Another reason why assistance was considered not to be as deserving as with the European Recovery Programme was that then the aid was clearly helping to reduce the chance of Communism spreading to Western Europe, whilst giving credits to the Soviet Union in 1991 might have simply allowed the old Communist nomenklatura to survive. Furthermore, in exchange for the Marshall Plan the US obtained concrete political leverage and military/strategic advantages, none of which were part of the assistance deals to the USSR.³⁰ Many also believed that the very concept of large-scale, official aid could never help to abolish the socialist system, as it had many similarities; in the opinion of Paul Craig, a former economic advisor to President Reagan, now with the Centre for Strategic and International Studies, 'the Harvard scheme and communism are similar in that they share the idea that society is a process that can be designed at the centre, and led from the centre'.³¹ All of these arguments entirely failed to suggest a positive approach to replace the 'Grand Bargain', however - all they implied was that the West should continue granting nothing more than the purely token amounts being offered so far, or else offer nothing at all.

²⁸ *The Guardian*, 28 August 1991.

²⁹ *The Guardian*, 8 June 1991.

³⁰ Michael Hughes, 'Can the West Agree on Aid to Eastern Europe?', *RFERL Research Report*, vol. 1, no. 11, 13 March 1992, p. 36.

³¹ *The Guardian*, 28 August 1992.

These were just some of the reasons (others, which were still to be major restricting factors a year later, shall be examined below) why Mikhail Gorbachev came away from the London G7 meeting with many enthusing messages of support, but little more substantial than relatively small-scale bilateral technical assistance. This was to be remembered with much criticism and guilt when the conservative elements of the Soviet government attempted a *putsch* on 19 August 1991; British Prime Minister John Major, as the host of the previous G7 meeting, subsequently attempted to reopen the debate on aid. The key period had been wasted already, however. During the early period of *perestroika*, when the level of support and motivation of reforms was at its highest, is when the positive effect of aid which affected the person on the street directly would have been at its greatest. Those who had argued that the EC and its partners must not build up the optimism of the Russian people over the benefits of a new period of cooperation with the West, merely to let them down with a lack of concrete material aid to support the verbal backing, had their worst fears realized. Already by the end of 1991, Western Assistance was fighting an uphill battle, because of the lack of opportunity shown by the EC and the rest of the Western world.

New Country, Old Empty Promises

When Moscow asked for aid after the August *coup*, the new level of credibility and Western concern for the survival of Gorbachev and El'tsin's pro-democratic governments made it more difficult for the West to back down. In late summer 1991, the Soviet government requested nearly \$15bn in Western assistance, for food purchases (later modified to \$10.2bn); in October, the response of the G7 nations was to pledge a 6bnECU (\$7.4bn) food and medicine credit facility, 2bnECU of which was to be provided by the EC, and the remainder being offered by Canada, Japan and the US. In fact, however, not all of this credit was new money; the EC's 2bnECU, for example, included the previously pledged

250mECU food aid grant, and 500mECU credit guarantee. The new element of the EC aid was a 1.25bnECU medium term loan to the FSU (see section 4.3).³²

There were many more months of debate, compromise and lack of clear leadership from any country or organization as to what further assistance should be granted to the ex-USSR. President Bush finally announced in the spring of 1992 that a \$24bn 'package' was to be offered, again by the G7 states, on condition of Russia's economic reforms proving to be effective. Presenting Western aid in such a packaged form was an attempt to give the impression that this was comparable to the volumes of assistance considered in the 'Grand Bargain', yet this was by no means the case. The now famous \$24bn was only a 'package' in the loosest sense of the word; it was in fact an amalgamation of many independent packages of bilateral aid, multilateral aid, and debt rescheduling. Even more misleadingly, an important part of this \$24bn again consisted of already committed aid; according to Grigorii Iavlinskii, \$11bn of the package was already committed bilateral credit, tied to donor state exports.³³ Although by the summer of 1992 \$4-5bn of these bilateral credits had been used, other parts of these credits had been blocked on account of the growing arrears on existing debt.³⁴ An estimated \$2.5bn of the package was in deferred debt or interest repayment, and \$6bn of it consisted of the hypothetical stabilization fund which had still not been granted by the end of 1994.³⁵ Even the part of the \$24bn intended to be from multilateral organizations, that is \$3bn from the IMF and \$1.5bn from the EBRD, had already been agreed in principle, though the IMF funds were then dependent upon Russia fulfilling very strict conditions (see section 4.4). 'The perception of a \$24bn package is a combined result of a political operation of the (Washington) White House, and of the ignorance of

³² Perdita Fraser, 1992, op. cit., p. 34.

³³ Grigorii Iavlinskii's Centre for Economic and Political Research, 'Spring '92 Reforms in Russia', *Moscow News*, nos 21 and 22, 1992, p. 4.

³⁴ Perdita Fraser, 1992, op. cit., p. 35.

³⁵ Grigorii Iavlinskii, op. cit., p. 4.

many journalists'. according to the then Head of the IMF representation in Moscow, Jean Foglizzo.³⁶

Despite the fact that the \$24bn was far more a public relations exercise than an offer of significant new aid, the mere fact that Western governments wanted to be seen to be giving large-scale help was important. Not only was the G7 keen to have generous sums of assistance publicized, but even conditions tied to the aid were in some cases slackened. This was true in particular of the first \$1bn tranche of IMF credit (described in more detail in section 4.3), granted despite the minimal achievements of economic reform goals. This suggested a change in policy, possibly a realization of the political pressure bearing down upon Egor Gaidar and his policies. It also constituted a move away from the use of the promise of aid as a lever for the execution of reforms and for the protection of reformers, a view favoured then by Jeffrey Sachs, rather than actual disbursing to try to appease the critics of reforms.³⁷

This one example of increased leniency rather went against the grain of 1992 as a whole, a time when the momentum of readiness to commit many resources and much effort to help the FSU decelerated notably, for numerous reasons. The worsening of the situation in the Former Yugoslavia, and the famine in Somalia and other parts of Africa were areas of greater need for humanitarian aid. The lack of readiness to provide more large-scale restructuring capital was closely linked with the continuing global economic recession. Two of the three main economic powers, the USA and Germany, were dealing with huge budget deficits. In the United States, for example, polls 'suggest that, despite genuine sympathy for the Soviet Union, most Americans want to see their money spent at home rather than on aid efforts abroad'.³⁸ Although the \$250bn in five years talked about in the Grand Bargain was no more than the Japanese surplus, most of the latter was already committed (to say nothing of the political issues restricting

³⁶ Author's interview with Jean Foglizzo, Head of the IMF's representation in Moscow, 14 October 1992.

³⁷ Philip Hanson, 1992, *op. cit.*, p. 55.

³⁸ *The Guardian*, 28 October 1991.

Japan's assistance to Russia). Neither was that amount more than West Germany has ploughed into East Germany, yet the whole of Europe felt the cost of that scale of capital inflow, as interest rates were forced up, resulting in a downward pressure on spending and jobs, these problems being magnified greatly in Germany itself. Consequently, Germany's role in talks on assistance to Russia was reversed from that of pace-setter for generous packages to that of begrudging member of the G7 on new development spending or debt rescheduling for the FSU. With its balance-of-payments problems, Germany is now obliged to remind the other powers that it has given far more than its fair share of aid, and that on the debt issue it has a great deal more to lose. All these factors meant that actual levels of aid were a mere fraction of the amounts needed. A report financed by the IBRD as part of its Technical Cooperation Programme was a full study of the state of the Russian economy, released in September 1992. This study not only confirmed the dire economic crisis, but it also highlighted the inadequacy of Western assistance to date. The report suggested that a minimum of \$20bn p.a. of foreign injections would be needed to truly increase the chances of the economic reforms' success.³⁹ Even Michel Camdessus, Managing Director of the monetarist-minded International Monetary Fund (IMF), said at the Lisbon Conference (23-24 May 1992) that the international community would have to find over \$30bn per year to save the reforms in the FSU.⁴⁰

In part because of the German-led European demands for the rest of the developed world to play their part in supporting the Russian reforms, there has been a distinct increase in the USA's readiness to help the FSU, bringing the Americans closer to Europe's approach. This has occurred not only in recent talks on the rescheduling of Soviet debts, where the cost to Washington reflects the USA's relatively small outstanding loans. The United States position on technology trade with Russia has also undergone massive change. This has been apparent in the joint USA-Russia plans to develop joint space projects (where it

³⁹ *The Financial Times*, 21 September 1992.

⁴⁰ *The Guardian*, 25 May 1992.

seems likely, nevertheless, that it will be more a case of the US buying technology rather than sharing its own state-of-the-art discoveries). More importantly, Washington finally agreed to dissolve CoCom, and to replace it with a new organization which is to include Russia.⁴¹ In practice however, it has become apparent that the new organization will also restrict the export of sensitive military and dual-use technology to certain countries, in some cases Russia and China; again, the Americans are being blamed for this continued prejudice against Russia, and the West Europeans are seen as the only hope for a more trusting approach.⁴²

This feeling of continued discrimination against Russia, of still being on an 'untrustworthy' list, adds to the general feeling of frustration and betrayal many feel with regard to the West. This is not purely an ideological antagonism, as described in chapter one. Many commentators who remain pro-marketeers are nonetheless very disappointed with the West's performance in terms of assistance to Russia. Aleksei Pushkov, editor of the *Moscow News*, wrote that

The main mistake was to oversell this assistance to the Russians. [...] the Russian masses never felt any real increase in their living standards as a result of this aid, for it was clearly insufficient. Some Russians tended to believe that all the fuss about the foreign economic aid was a huge hoax [...] ⁴³

Even when aid credit is actually granted, complains another commentator, the problem is that it is often spent on consumer imports, thus allowing the industrial base to disintegrate further, and with no hope of having increased production enough to back these loans when they become due.⁴⁴ Although it may well have been advantageous from the Western side, for political reasons, to give an enormous amount of media attention to aid, for many Russians the result has been a loss of faith in Western assistance. An important distinction should be made

⁴¹ *The Financial Times*, 17 November 1993.

⁴² 'MN Biznes', in *Moskovskie novosti*, no. 14, 3-10 April 1994, p. B1.

⁴³ Aleksei Pushkov, 'Russia and the West: an Endangered Relationship?', *NATO Review*, February 1994, p. 21.

⁴⁴ Evgenii Gudkov, 'Pomoshch' zapada: na chto rasschityvat?', *Literaturnaia Gazeta*, no. 2, 11 January 1991, p. 4.

between publicizing actual aid and advertising potential commitments. It is the latter which has been very damaging, especially as El'tsin's foreign policy was based to a significant degree on Western assistance proving worthy of the sacrifices being made in geopolitical terms.

There has also been much criticism of EU aid in particular. One main complaint has concerned the amount of aid spent on salaries literally hundreds of times the size of Russian specialists' wages. Worst of all, according to the Vice-Chairman of the Russian Agency for International Cooperation and Development (RAICD) Aleksandr Zhitnikov, 'half of what the Western consultants write is no good'.⁴⁵ Another criticism is that Western consultants are paid handsomely to establish a presence in the developing Russian market, whilst often leaving little in their wake, as the proportion of TACIS spending on equipment is small, never exceeding 30-35%.⁴⁶ Also a bone of contention is the amount of resources spent on feasibility missions from the EU, when much of this work could be done more cheaply by Russian and Western staff based in Russia, who normally have a better understanding of local conditions.⁴⁷ This leads on to the general point of the assistance specialists' attitude towards the beneficiaries. Not only is it considered by Russians involved with TACIS that too little use is made of Russian specialists, or at least Russia-based Western staff; there have also been regular instances of aid consultants simply translating and presenting material which is not applicable to Russian circumstances. Although these criticisms can to a large degree be rightly rejected by the Commission, as shown in the next section, the fact still remains that instead of encouraging a general feeling of gratitude and friendliness towards Western Europe, even the EU's aid has sometimes caused irritation. The author can vouch from his own work with the Russian business community that the level of frustration with and cynicism

⁴⁵ *The Economist*, 10 April 1993, p. 21.

⁴⁶ Interview with Igor Markov, Director of the CU, 30 September 1992.

⁴⁷ Interview with Viktor Vladimirovich Inozemtsev, Russian Coordination Unit, responsible for Nuclear Projects, 25 September 1992; the fact that most feasibility missions are undertaken from specialists based in Western Europe and with often limited knowledge of Russian conditions was witnessed by the author during work on the structuring of TACIS projects.

towards Western consultants is very high, both because of the high salaries they earn and the often low level of relevance of what they right.

In the spring of 1993, it seemed as if Western leaders had finally realized, particularly considering the degree of poverty and anger in Russia, that it was time to grant more aid, with less conditions; in other words, it should have been accepted that the level of influence of statecraft would have to be lowered, despite volumes of aid increasing. The clearest sign of this was yet another impressive-sounding 'package', announced at the Tokyo G7 Summit, supposedly offering \$43bn. Again, however, it contained a high proportion of 'recycled' aid, as well as very hypothetical elements. Debt rescheduling accounted for \$15bn of the package, of which \$6.5bn was deferred from 1992. The most important part of the package was a promise of \$18bn of IMF and IBRD funds, but \$6bn of that was the same stabilization fund which had been promised in 1992.⁴⁸ In fact, only approximately \$2bn of the IMF and World Bank credits were disbursed in 1993 (see section 4.3).⁴⁹ It was another case of large numbers at press conferences not translating into much real assistance. President El'tsin joined in the strong criticism of the slow implementation of Tokyo promises.⁵⁰ The amount of disillusionment with promises of Western backing naturally kept growing, and is likely to have been a factor in the strong Liberal-Democrat turnout in the December 1993 elections to the State Duma.

Predictably, the new political clout gained by Vladimir Zhirinovskii triggered off a new set of promises for greater aid and faster action. Finally, the G7 office in Moscow which had been promised in April 1993 was opened; the second \$1.5bn tranche of IMF credit was approved in March 1994. In terms of multilateral aid, however, there was nothing else of substance which had emerged by mid-1994. The many comments by policy makers, following the Russian election results, about the need to try to prevent a strong increase in the support for nationalist/populist politicians by massively increasing aid to Russia,

⁴⁸ *The Guardian*, 16 April 1993; and IMF, op. cit., 1994, p. 78.

⁴⁹ IMF op. cit., 1994, p. 78.

⁵⁰ *The Guardian*, 15 January 1994.

disappeared with the headlines about Zhirinovskii. Assistance to Russia is clearly going to continue at an increasing rate, but not at a level even approaching the amounts saved by the (present) termination of the Cold War, nor even realizing the promises given by the G7 'packages'. There is of course no guarantee that granting more aid, and aiming more of it at Russian consumers rather than Western consultants, would have greatly reduced the Slavophile backlash which has occurred in the last few years, but it could at least have made Western aid a useful tool for pro-reform politicians, rather than the weapon of populists which it has now become.

4.3 The European Union's Assistance to Russia

The Special Role of European Union Aid

The role of the European Union in Russia truly differs from that of other institutions. The 'family relationship' talked about by the EU Ambassador contrasts starkly with the 'doctor-patient' relationship of the IMF with Russia. The fact that the EU is not a financial institution like the IMF or the World Bank allows it not to insist upon the same harsh macroeconomic prerequisites for the approval of large-scale aid programmes. The special case of the EU derives not only from its proximity to Russia, but from its dual role as a representative of its member states as well as of the supranational Commission of the EU *per se*. As such, the EU accounts for the vast majority of aid to the FSU; of the pledges of almost 70bnECU (this may exclude sections of the \$24bn 'package') committed between September 1990 and mid-May 1992, approximately 74% originated from the EC and its member states.⁵¹ The proportion is similar for the period 1992-93,

⁵¹ Perdita Fraser, 1992, op. cit., p.35. This figure excludes debt rescheduling, as well as grants from private sources: the figure was only slightly less in early 1994, in terms of aid actually delivered, according to Martin Walker: of the \$94.4bn (77.6bnECU) received from the West by the FSU, 64.1% (\$60.5bn or 49.8bnECU) was from the EU — from *Europe — Magazine of the European Union*, (published in Washington) no. 333, February 1994.

when the EU Member States provided a total of \$44.5bn in export credits and loan guarantees to Russia, representing 66% of the total for G7 countries.⁵² The aid of the Community itself, as an institution, is relatively modest: for the period September 1990 to mid-May 1992, it represented only 5.8% (3,013mECU) of the EC's total aid to the FSU,⁵³ the remainder being bilateral aid. Although the proportion of Commission aid may seem negligible, we shall see that the nature of it makes it potentially very valuable.

One example of the Community's youthful and dynamic approach to problem-solving is the creation of the European Bank for Reconstruction and Development, conceived by François Mitterrand during his presidency of the European Council, and in which the EU has played an important part ever since (see section 4.4). In the sphere of international coordination, the EC participated closely in the January 1992 international conference on assistance to the FSU in Washington and it prepared the Lisbon Conference in May of that year. The Community has also encouraged the Russian government to establish a coordination body, which has taken the form of the Russian Agency for International Coordination and Development (the RAICD — elaborated upon in section 4.4). There was a time when the possibility of the EC coordinating the whole of Western assistance to the Soviet Union, just as it has been coordinating all multilateral OECD assistance to Eastern Europe, was seriously discussed. At the Rome Council of December 1990, however, it was decided that the USSR would not be included in the PHARE programme of assistance to Eastern Europe, but instead the Technical Assistance to the USSR programme was launched (later becoming the Technical Assistance to the CIS programme, or TACIS). Although the Baltic states were originally included in TACIS, they were subsequently amalgamated with the PHARE programme. The very concept of TACIS has

⁵² *Europe — Magazine of the European Union*, (published in Washington) no. 333, February 1994, p.8.

⁵³ This includes the 1992 TACIS programme, but excludes technical assistance to the Baltic states.

turned out to be very different from that of PHARE, largely because of the CIS' greater distance from Western Europe, and because of its immensity.⁵⁴

Until relatively recently the EC had very limited influence as a participant in economic statecraft with the USSR. This had been due to the fact that most Soviet exports were not covered by the Community's commercial policy; oil, gas and raw materials enter free of tariff or quota, as the EC member states kept control of their energy supplies. Also responsible was the fact that CoCom, as well as most of the institutions which previously provided credit to the USSR (mostly national governments granting bilateral deals), had all been outside the EC's jurisdiction.⁵⁵ As EC member states still kept control over policy instruments which were vital in relations with the USSR, namely energy imports and granting credit, they had also kept control over the main levers of economic statecraft. In the field of energy trade, the European Energy Charter may bring about a situation where energy trading conditions are controlled jointly by Europeans from East and West, once agreement is finally reached (see Appendix Two).

As concerns purely EC help, from its very beginning it had an important statecraft element. The 250mECU grant for food aid approved at the December 1990 Council meeting was suspended in early 1991 after the Red Army's intervention in Lithuania (together with KGB and MVD forces), and then resumed in May on condition that constructive dialogue continued to be held between Moscow and the Baltic republics. The 1.25bnECU in credits accorded at the end of 1991 were also not free of conditions; they were granted on the basis of commitment to market principles, and pluralist democracy, although in cases of real hardship these were ignored. It had also been a condition that the Memorandum of 28 October 1991, regarding the debt to foreign creditors of the USSR and its successors, would be signed (this agreement is now obsolete, as

⁵⁴ Author's interview with Mr. D. Ivarsson, responsible for procurement and contracting in TACIS' Coordination Unit, 6 October 1992.

⁵⁵ John Pinder, 'The EC and Eastern Europe Under Gorbachev: How Normal Could Relations Become?', in *The Economies of Eastern Europe Under Gorbachev's Influence, NATO Colloquium, March 1988*, Brussels, 1988, p. 266.

Russia and the republics eventually reached 'zero-option' agreements: see section 4.4). Significantly, they carried the traditional waiver of sovereign immunity, which remained an obstacle to agreement for a long time. The 1,860mECU committed in technical assistance to the CIS (including 40mECU for the Baltic states in 1991 and 1992, and an unspecified amount for Mongolia in 1994), on the other hand, has been relatively free of conditions. Naturally, if the government of any of the beneficiary states clearly ceased to carry out democratic and market-oriented reforms, their share of TACIS would be reduced or dissolved, but there are no clear parameters as to what would constitute a breach of the reform process.

There now follows an examination in more detail of the three types of assistance which the Community has so far granted to Russia — food aid, credit guarantees and loans, and the most important part, technical assistance. The section ends with an appraisal of how EU assistance to Russia might be expected to change in the future. The detail provided in the following sections is included to show where Russian (and Western) criticism of food aid and of TACIS programmes can be justified, and on the contrary which aspects of EC/EU aid is particularly well thought out.

Food Grants

The first type of aid to be offered by the European Community to the Soviet Union was food aid. The role of food aid in EC cooperation was crucial, and the reasoning behind it simple: 'there can be no political or economic reform on an empty stomach'.⁵⁶ EC food aid consisted of non-repayable grants which could be used to purchase foodstuffs, normally from EC states, though in some cases from Eastern Europe. The first grant for food aid, as noted above, was for 250mECU

⁵⁶ *Food and Humanitarian Aid*, documentation produced by the EC Commission for the Lisbon Conference, 23-24 May 1992.

and was approved at the Rome Council in December 1990. The grant was used mostly to purchase products from government surplus stocks, though others were bought on the market by the Commission after offering tenders. Part of the aid consisted of approximately 26,565 tonnes of foodstuffs being supplied directly to the governments of the Central Asian Republics. The major part of the operation, however, was in delivering 88,000 tonnes, mainly to Russia, Ukraine, Belarus, Georgia and Armenia through non-governmental organizations (NGOs). The whole process proved to be painstakingly slow; by April 1992, only around half of the 88,000 tonnes pledged at the end of 1990 had reached their destination. Some of these NGOs were themselves working with corresponding organizations in the CIS.⁵⁷

For a closer look at the mechanism of distribution for this food aid, the work of Médecins Sans Frontières / Belgique (MSF) can be used as an example. For the programme approved by the December 1990 Rome Memorandum, MSF was involved in the distribution of baby food, milk and pasta. Before distribution commenced, the distribution points were contacted, to determine how many children, of the appropriate age, MSF would have to feed in the capital. The distribution of ordinary milk and pasta was part of a second wave of dietary assistance. The foodstuffs were separated into ten prefectures of Moscow; each prefecture then providing a list of its neediest people: old age pensioners, large families, invalids, and other needy groups. The prefectures then sent out notices to these people inviting them to come and collect the donated food, which was granted upon presentation of this notice, the recipient's old age/invalid/large family card and his/her passport; after receiving their parcel, the beneficiaries signed a receipt.⁵⁸ In this way, the first year's food aid programme, eventually, reached the people it was destined for. Although the amounts distributed were small, they appeared to be well targetted. This programme can be seen as having been successful at both improving living standards of a small section of Russia's

⁵⁷ *Food and Humanitarian Aid*, op. cit.

⁵⁸ *Résumé des activités de Médecins Sans Frontières en CEI depuis 1988*, par l'Equipe MSF/Belgique à Moscou (as.036).

needy, and increasing their good will towards the EC. On the other hand, as will all food aid to Russia, it failed to address the problem of decreasing production and reliance on imported goods, and was the target of Russia nationalist attacks on the West's demeaning charity to a world superpower, needed only because of the poverty inflicted on Russians due to Western policies.

The other purely food aid programme of the EC was announced one year after the first one, at the Maastricht Council meeting in December 1991. The aid from this operation was originally to be aimed only at Moscow and St Petersburg, although this was later extended to include Saratov, Nizhnyi Novgorod and Cheliabinsk. Apart from an initial 5mECU of food and medicines which was allocated in the same way as in the original operation, the distribution tactics for this programme were more complicated than for the first year. In the first stages, the aid was not to be distributed directly to recipients, but to shops. The participating retail outlets in Moscow and St Petersburg were provided with bright blue and gold European Community stickers; this time recognition was clearly one of the objectives. The foodstuffs were sold at fixed prices, at levels aimed to be high enough not to discourage local production, but low enough to have a downward effect on the inflation which had accompanied the chaotic start to price liberalization. The next stage of food aid was intended to simultaneously assist the development of a new supply structure, using commodity exchanges. EC food was auctioned off at commodity exchanges, to shop managers and distributors, who were then allowed to add a mark-up of 20%. Buyers were to have their identities verified, and their outlets randomly checked to ensure that the food was neither overpriced, nor sold on the black market.⁵⁹ Where sold directly through shops, or indirectly through auctions, the revenue from the sales of the food was placed in a hardship fund, which was then used to top up social security payments to similar categories to those which were targeted with food distribution, if somewhat broader. In Moscow, for example, some two million people were to

⁵⁹ Interview with Elena Prokhoreva, of the Moscow Delegation of the Commission of the European Communities' Information Office, 2 November 1992; also *The Times*, 4 January 1992.

have their pensions or social security payments significantly increased. for a few months. due to this fund. Some of the money was also used to pay for hot school meals.⁶⁰ The Commission employed a total of over 100 people, primarily soldiers, but also other staff seconded by the Member States: use was also made of consultancy firms to ensure both the sales in shops, and later in public sales, as well as to monitor that the counterpart funds were being used properly.⁶¹ The 250mECU aid package has been particularly praised as a model of efficiency, its delivery time, at least for the first half of the operation, having been relatively speedy, and the proportion of misappropriated food being very low. It was also considered a success in helping to develop market mechanisms within the FSU.⁶² However, there was criticism about Russians having to pay for this 'aid', the perception being that the EC making money from its food surpluses at the expense of Russian consumers, as much of the population did not know or did not believe that the proceeds were being re-directed towards the poorer citizens of Moscow and St Petersburg.

Food aid may continue to be funded by the EU, this time using TACIS funds. Starting from the 1993 TACIS budget, up to 10% of TACIS funds will be available for humanitarian needs, if justified by circumstances. Such a system has already been in use with the PHARE programme.⁶³ Although this is more likely to be needed in the states of Central Asia and the Caucasus, the theoretical possibility is there also for Russia, although this seems very unlikely to happen. The criticism of food aid described above have pushed the EU firmly into financing technical support of Russian production or service sector enterprises, aiming at the more long-term benefits of this type of aid.

⁶⁰ *Food and Humanitarian Aid*, op. cit.

⁶¹ *Food and Humanitarian Aid*, op. cit.

⁶² Interview with Michael Emerson, op. cit.

⁶³ *TACIS — Annual Report from the Commission — 1991 and 1992*, Commission of the European Communities document, COM(93)362 final, Brussels, 28 July 1993, p. 46.

Credit Guarantees and Loans

The second part of the aid package agreed at the Rome Council at the end of 1990 was the 500mECU credit guarantee. This assistance was also tied to food, but contrarily to the grants described above, it had to be repaid. This capital was to be used against a loan which was originally to be granted to the Vneshekonombank by a consortium of banks led by the Deutsche Bank.⁶⁴ The loan was at first to be used purely for EC food products, but this was then extended to East European products, which could account for up to 25% food products purchased with these credits. The idea behind this scheme was not only to help East European recovery at the same time as alleviating some of the hardship in Russia, but also to reduce pressure from East European exporters on the Western markets. Nonetheless, this aspect did provide more scope for choice on the part of Russia than habitual bilateral credit arrangements.

The delays in reaching final agreement on the terms for this credit were enormous, as finding a Soviet counterpart with the appropriate responsibility was at first problematic, then simply impossible with the collapse of the Soviet Union. It was only after the European Council agreed to transfer the responsibility for the credit guarantee that the appropriate promises could be obtained and letters of credit exchanged with Vneshekonombank, the latter being able to provide the guarantee money to the consortium of Western banks.⁶⁵ This had occurred by the end of May, although by this time, after interest had been taken away, only some 406mECU were left in credit.⁶⁶

This problem of finding the right interlocutor to achieve one's goal in the FSU, and determining which competence and spheres of influence a potential partner or negotiator has in reality, is a major difficulty for every type of aid programme, just as it is for business. The collapse of the Soviet Union, for all its

⁶⁴ Perdita Fraser, 1992, op. cit., p. 33.

⁶⁵ *Interfax* in English, 21 February 1992.

⁶⁶ Perdita Fraser, 1992, op. cit., p. 34.

beneficial results, has greatly worsened this particular drawback. Much time and energy is wasted either through untenable promises, or through the need to make parallel arrangements and agreements with local, regional and republican authorities, to avoid one of these vital links refusing to cooperate.

The other pledge of EC credit that we have seen to date is the 1.25bnECU medium-term loan, approved at the December 1991 Council meeting, which made up EC aid figures to the 2bnECU promised at that summer's G7 meeting. Each republic's proportion of this loan, which is intended for agricultural, food or medicinal products, was later balanced in accordance with Russia being the sole benefactor from the 500mECU credit guarantee. Russia's share of this loan has thus been set at 499mECU, all of it to be used on food (mostly wheat) and medicines. Although the Commission had signed memoranda of understanding on these loans with Belarus, Kyrgyzstan, Tajikistan and Turkmenistan by December 1992, only in the spring of 1993 was such a memorandum signed with Russia,⁶⁷ which had previously refused to agree to the waiver of sovereign immunity, in the event of defaulting on repayments, leading to the necessity of appropriating Russia's assets abroad. Thereafter this very important sum, the largest single amount granted to Russia by the Community, could be translated into badly needed medicines and cheaper food.

Afterhaving granted these loans, the EC concentrated on financing TACIS: as explained below, the author believes that offering new credits to support Russian reforms would be a wise investment of European tax payers money, if this debt was exclusively tied to the development of projects which had been identified and supported by TACIS consultancy projects.

⁶⁷ 'The Delegation of the Commission of the European Communities: A Second Year in Moscow'. press release by the Delegation of the Commission of the European Communities in Moscow. 25 March 1993.

Non-TACIS Energy Programmes

Before moving on to TACIS, it is worth briefly mentioning an area in which TACIS funds can be supplemented by other EU bodies. There are two such programmes run by the Community which have been involved in energy projects concerning Russia: Thermie and the International Energy Cooperation Programme (IECP).

Thermie is the Community Programme for the promotion of energy technologies, which since December 1991 has been empowered to undertake activities in the FSU. By mid-1992 it had opened three energy centres in Russia: Moscow, St-Petersburg and Tiumen'; the centres at Moscow and St Petersburg were strengthened by TACIS (1991) funding amounting to 2.5mECU each. The main objectives of the centres are: to promote the transfer and use of efficient European energy technologies; to provide a permanent representation of European energy technology experts; to facilitate the establishment of European equipment manufacturers and suppliers, as well as defining opportunities for joint venture actions. As an example of the benefits which have been achieved, the EU Energy Centre in Moscow had already completed fourteen actions by mid-1993. It has been estimated that these actions will produce energy savings of 2.5 GJ over the next five years, for a cost of only 318,000ECU, which represents a pay-back period of just over two months.⁶⁸

The International Energy Cooperation Programme (IECP) is a body run by DG XVII which covers energy assistance to the developing world and the former Communist bloc. Funding amounts are modest, at around 3mECU for 1992 and 4mECU in 1993. An advantage of the IECP is that it covers all Eastern countries and can therefore cut across boundaries, for example by jointing PHARE and TACIS recipient countries; this is especially important considering the important

⁶⁸ The Commission of the European Communities' Directorate General for Energy (DG XVII), 'Community Assistance in the Energy Sector to the Countries of Central and Eastern Europe and the FSU', in *Energy in Europe*, Special Issue, August 1993, pp. 11-12.

energy links remaining between these countries. Projects in the 1992 IECF involving Russia included a seminar on demand-oriented energy policy; workshops on energy legislation and regulation, with emphasis on the European Energy Charter; study tours for energy policy-makers from the FSU to provide direct experience of energy policy and the Charter principles in practice in EC member states; and a workshop on social and economic reconversion of coal fields. The Energy Cooperation Programme has also worked together with Thermie and TACIS by assisting with the initiation and support for EC Energy Centres. The IECF has furthermore provided financial support for the administrative costs of conducting European Energy Charter negotiations.⁶⁹

Technical Assistance to the CIS

After two winters of massive food aid, from 1990 to 1992, by the time of the Lisbon Conference the emphasis was much more on self-help, on 'helping the new republics feeding themselves rather than us feeding them'. This is the whole philosophy behind the Community's Technical Assistance, an ambitious project of extensive transfer of know-how to the FSU. The concept of a technical assistance programme to the Soviet Union was first officially approved by the European Council in Rome in December 1990. On 15 July 1991, the Council adopted a regulation on the implementation of the Technical Assistance Programme for the Soviet Union which provided it with a budget of 400mECU. Already this was far more than any other non-refundable know-how transfer project from the West, even though the amount pledged in following years was to be higher still. TACIS is by far the most visible aspect of EU assistance to Russia, and therefore merits particular attention as a major source of publicity, gratitude as well as frustration from the Russian recipients.

⁶⁹ Ibid., pp. 12-13.

In its approach to helping liberal reforms, one of the objectives was to encourage Soviet society to organize itself, without the need of directives.

A prerequisite to the successful evolution of a market economy is the emergence of a democratic society. Therefore, the Technical Assistance programme will encourage the establishment of those formal and informal organizations that are vital for the development of a pluralistic democratic civic society.⁷⁰

Assisting the privatization process has also been a general goal of this operation

Discovering precisely which were the most urgent tasks was a challenge in itself. 'The inability of the Soviet authorities to translate an infinite number of needs into a limited number of clearly formulated and concrete projects enormously complicated the task of the Commission'.⁷¹ Nevertheless, an Indicative Programme proposal for 1991, signed jointly by EC Commission Vice-President Andriessen and the USSR's Ambassador Voronin, was approved by the Twelve on 22 July 1991.⁷² The main objective of the Programme was to support measures promoting the transition to a market economy in the USSR. Five priority sectors were identified: training, energy (including nuclear safety), financial services, transport, and food distribution; there was also a miscellaneous section, which included, *inter alia*, telecommunications and the environment. Assistance was to be provided in these areas mainly through policy-making advice, the design of suitable legal and administrative frameworks, training, the reorganization of existing institutions and the establishment of new ones. The assistance was to be concentrated on sectors and geographical areas where it was most likely to play a key role in the continuation of the reform process.⁷³ This

⁷⁰ *Russia — 1992 Technical Assistance Indicative Programme*. Programme agreed at a series of meetings between Representatives of the Russian government and of the EC Commission, in February-March 1992. EC Commission document. No date.

⁷¹ *Background Brief. TACIS — Technical Assistance to the Commonwealth of Independent States. Implementation 1991 — Programming 1992*. EC Commission document. No date.

⁷² *Technical Assistance to Economic Reform and Recovery in the USSR, 1991 and 1992. An Operational Guide*. EC Commission Document. No date.

⁷³ *Ibid.*

was considered to be an important mechanism with which to encourage those regional leaders which proved themselves to be true reformists.⁷⁴

Now that the priority areas of training, energy, financial services, transport and food distribution had been established, the search for appropriate projects could begin. Any proposal for Technical Assistance (TA) funding must, at least in theory, originate from the potential benefactor, and it should first of all be sent to the recipient country's Coordination Unit (CU). The CU acts as the link between the EC Commission or its Moscow Delegation, and targeted benefactors. It consists mostly of Russian experts in the priority areas, and has been complemented by Western experts, seconded at the cost of the Commission. The USSR Coordination Unit had only just managed to start operating in the late summer of 1991 when the *coup* greatly complicated its task. The first part of the CU's responsibility within its own country is to inform all potential recipients about the nature of EC technical cooperation and the terms of access to funding. All project proposals put forward by local bodies were to be sent to the CU for evaluation, with satisfactory ones being sent through to Brussels as official finance requests; from 1992 these were to be signed by the National Coordinator. To achieve this 'filtering' role, the CU attempts to retain only projects which are compatible with goals set out in the Indicative Programme.

For many reasons, the preparations for the 1991 TA programme were not so smooth in practice. The main delaying factor was the August *coup*, and the resulting institutional chaos as Russian government bodies started to take over from Soviet ones. Despite this mayhem, from August to December, 400mECU worth of projects had to be found; any of the TA budget not pledged by the end of the year was to be returned to Community coffers. Even without the political uncertainty, this would have been impossible to do thoroughly and systematically, especially as this was the Programme's first year, involving much trial and error. The result was that neither the CU nor Brussels could afford to be too particular about which proposals should be examined further in identification missions; a

⁷⁴ Interview with Michael Emerson. *op. cit.*

'rule of acceptance' became the norm, according to the Head of one Western consultants' firm which managed to secure contracts during this period. The insufficient time available for the CU to make clear to all potential benefactors the precise conditions of EC technical assistance also led to misunderstandings, and often frustration. Sometimes, at this stage, the Western partner had to go to Russia to placate the beneficiary, and persuade them to sign the Statement of Endorsement for a project which is different from what they had expected. 'Once we're on site, we find solutions.' was the approach of one consultant.⁷⁵

One of the objectives of the 1991 TACIS programme was to privatize enterprises, but when 1991 projects were being approved, virtually all companies in the USSR were still state owned; this meant that the approach of management became a vital determining factor, but knowledge of this was very limited, especially amongst the Western specialists who chose projects during identification missions.⁷⁶ From the point of view of the CU, its task of disseminating knowledge of the TACIS programme was much easier to achieve amongst large centralized structures, or their inheritors, due to the nature of their approach; amongst independent enterprises, information was still badly lacking.⁷⁷ Thus numerous projects were selected whilst only a minority of eligible enterprises knew of the existence of this opportunity to obtain EC know-how. The rushed procedure and the lack of information for 1991 projects also meant that many Russian managers who had their project approved realized only afterwards that it did not involve having the project's budget to spend at will, nor even large scale acquisition of equipment.⁷⁸ These two negative aspects of TACIS' first year were the source of much Russian criticism, much of it justified.

After having been forwarded by the CU (although in practice, projects by Western companies or consultants were sometimes presented directly to the

⁷⁵ Meeting with a consultant working for BDPA Scetagri, France: 9 October 1992.

⁷⁶ *Background Brief. TACIS — Technical Assistance to the Commonwealth of Independent States. Implementation 1991 — Programming 1992.* EC Commission document. No date.

⁷⁷ Interview with Viktor Vladimirovich Inozemtsev, Russian Coordination Unit, responsible for Nuclear Projects, 25 September 1992.

⁷⁸ Interview with Igor Andreyevich Markov, Director of the Russian Coordinating Unit, 30 September 1992.

Commission). potential projects are studied by TACIS staff at the Commission, or contractors working for them, and the most interesting ones selected for appraisal by identification mission.⁷⁹ After these missions, projects (at least major ones) which are still considered worthy are kept, to be presented to the Management Committee for Technical Assistance to the CIS, and thus approved as part of concrete Action Programmes.⁸⁰ The Management Committee is composed of representatives from the Twelve Member States and is chaired by a representative of the Commission. Their decisions are reached by a majority in weighted voting (as when the Council must reach a decision on a proposal from the Commission), in which the Chairman does not vote.⁸¹ In the case of the 1991 Programme, the respective sectoral programmes were to be presented to the Management Committee in October (for energy) and November (for all other sectors). Any projects above 10mECU had to be individually examined and approved by the Management Committee.

By 12 December 1991, despite the teething problems, the *putsch* and the shortage of time, the five sectoral financing memoranda were ready to be signed by Vice-President Andriessen and the Chairman of the Inter-State Economic Committee of the USSR (later to become Ambassador to the EC), Ivan Silaev. The Baltic republics were dealt with separately, with 15mECU of the FSU's budget for their projects; there was also 7.3mECU set aside for the monitoring and implementation of the 1991 TA to the USSR. The most important division of the programme was that of energy, for which 115mECU was provided. Within this sector, the largest component was in the field of nuclear energy, for which 53mECU was allocated, concentrating on closing or improving the safety of existing reactors, and tightening nuclear safety regulation.⁸² The training

⁷⁹ Interview with Mr. M. Korvyakov. Russian Coordination Unit, Responsible for Food Distribution Projects. 9 October 1992.

⁸⁰ *Technical Assistance to Economic Reform and Recovery in the USSR...* op. cit.

⁸¹ Council Regulation (EEC, EURATOM) No. 2157/91 of 15 July 1991, concerning the provision of technical assistance to economic reform and recovery in the Union of Soviet Socialist Republics: Article 7.

⁸² *Indicative List of Projects, TACIS 1991 — Energy Sector*. EC Commission document (no date); also *TACIS — Operational Guide*, (draft 6 August 1992), op. cit., p. 10.

subsection of the 1991 TA was next in volume of capital, with 103mECU, of which management training received just over half.⁸³ The third section in order of spending was that of food distribution, accounting for 73mECU, the largest share of which went to 'Soviet Union-level integrated measures'.⁸⁴ Transport problems were not only addressed in the food distribution sector of TACIS, but also had their own sector, with financing worth 45.8mECU.⁸⁵ The fifth and final sector of the 1991 TA programme was that providing for financial services, worth 37.5mECU. Commercial banks receive by far the most attention in this field, with projects amounting to over 19.7mECU.⁸⁶

Although these Action Programmes had a very definitive appearance, they could by no means be taken as final; some of the above figures had in fact been changed (by the spring of 1992) from the time when they were first approved in the autumn of 1991, both in terms of amounts needed and projects targetted, as originally planned projects in practice often had to be altered, replaced or aborted, before some of the remaining bureaucratic stages had been crossed, even though Action Programmes had already been agreed upon. The procedure at this stage depends upon the amount involved in a particular project; if a project is worth less than 300,000ECU, an EC/EU company (or one from the FSU, in theory) specified for the task by the FSU recipient can be directly contracted, so long as the project itself has been approved. If a project is valued at more than 0.3mECU, however, the Commission's tender offering procedure has to be used. Tenders for service contracts are always restricted, which means applications are not encouraged through mainline press or the EC's official journal. Instead, applicants from the Commission's 'short-list' are invited to apply for these tenders; these are consultant or financial organizations which have applied for recognition on the Central Consultancy Register, and which have a 'proven' record in their field.⁸⁷

⁸³ *TACIS — Training Sector. Subsector — Management Training*; EC Commission document; also *TACIS — Operational Guide*, (draft 6 August 1992), op. cit. p. 11.

⁸⁴ *Draft Commission Decision of 1991 — approving a sectoral support programme for food distribution for the USSR*; EC Commission, no date.

⁸⁵ *Sector Transport (1991)*; EC Commission Document, no date.

⁸⁶ *Sector Financial Services (1991)*; also *Evropa*, September-October 1992, pp. E15-16.

⁸⁷ *TACIS — Operational Guide*, op. cit.; and conversation with the TACIS Info. office, Brussels.

Equipment needed for the projects, if valued at over 50.000ECU, is put out to open tender, for which any supplier from the Community or from the FSU can apply. The equipment content of these projects is always relatively small, as the emphasis is on the transfer of knowledge rather than hardware: only the equipment needed to facilitate this task is acceptable. Although there is no official limit to the proportion of equipment expenditure a project may have, it tends never to exceed 30%.⁸⁸

Even after one of the applicants for the tender has won the contract, the project is not settled; all that is offered to be signed at this stage is a draft contract, which is then returned to the EU Commission, before a real contract can be issued.⁸⁹

Another stage then to overcome is achieving approval of the final Terms of Reference (TOR), which are guidelines to the project which are drawn up by the Commission in Brussels; such agreement is needed by the former Soviet recipient, through the signature of a Statement of Endorsement. As noted above, this in itself is often a major obstacle, especially with the 1991 projects, when the Russian partner sometimes saw the truth of the project for the first time. It is sometimes the case that the draft TOR, which were used to draw up the Action Programme, have been substantially redefined by the Commission, compared to what had been requested by the Russian beneficiary, the Western consultant or the Russian CU. This, again, has been the source of much disenchantment from the Russian side, as well as from EC consultants. Once the Statement of Endorsement is signed and the real contract offered by the Commission for all to sign, the financing can finally be acquired; the Western company, though, still has to adjust its workforce and prepare its staff (see table 4.1).

It normally takes at least 4-5 weeks for a contract to be applied, after it is signed. For the 1991 programme, the first tenders were granted in January 1992. In practice, the execution of the post-identification stages of the 1991 TA

⁸⁸ Meeting with Georges Champseix . (Director) of BDPA Scetagri, France; 9 October 1992.

⁸⁹ Interview with Mr. Ivarsson, Russian CU. op. cit.

programme also proved problematic. After the initial rush to obtain budget approval, which must be finalized by 31 December of the year in question, there was a marked deceleration in the amount of tender procedures being completed and contracts being signed, which has prompted some expressions of frustration from tender seekers. By as late as March 1993, only 268.3mECU of projects (233 projects) had been identified, and only 170.0mECU worth of contracts had been signed (176 contracts).⁹⁰ Funds from the 1991 TA budget which had not been allocated by this time were not added on as extra funding for subsequent years, but merely credited back to the EC's budget.

Admittedly, it is not only the EC's slow bureaucratic procedures which are to blame for the long delays. Some of the approved 1991 projects could not be carried out by 1992, because the All-Union structures that were designated recipients no longer exist, nor did they have a Russian or CIS equivalent. This is not the case for many projects, however. Other projects were particularly time-consuming because of their extreme complexity; this was the case, for example, for nuclear projects. Nevertheless, the low rate of contract finalizations was indeed worrying. The slowness of execution of TACIS programmes due to the mass of bureaucratic procedures described above is the most common target for Russian criticism of the TACIS programme, together with the lack of funding with which to implement the restructuring which is often suggested to Russian entrepreneurs being consulted by TACIS projects.

This does not mean that nothing positive was happening. By the end of 1992, many projects were underway, and a few had even been completed. Despite this fact, in early 1993 there was still no evidence of independent consultants' (as opposed to those benefiting from the service contract) reports on the success of projects either completed or in progress, whilst neither the Commission nor its Moscow Delegation had the extra staff to work on Programme Managing Units (PMUs). TACIS guidelines specify that final

⁹⁰ 'Technical Assistance Dossier of Selected Projects; List of Projects, 1991: All Sectors — Russia', computer print-out obtained from the Moscow EC Coordination Unit, 9 March 1993.

benefactors should be closely involved in the appraisal of a programme; for this purpose, PMUs were to be set up, staffed both by EC consultants and officials at Republican or inter-Republican level (originally). These theoretical guidelines further state that as well as regular follow-up by the Commission's services and regular reporting by the PMUs, the Commission will conclude contracts with independent consultants to monitor the progress and the performance of projects and their various components as well as to undertake a comprehensive ex-post evaluation of whether the objectives of a project have been achieved.⁹¹

On the CU side of things, any project implementation work in the first year was limited to *ad hoc* trouble shooting. After the attempted *coup*, and the eventual dissolution of the USSR, the demise of the USSR Coordination Unit also became only a matter of time, a factor which could not have assisted the working atmosphere. Indeed, on the 1 January 1992, financing to the USSR CU was stopped, and new accommodation had to be found.⁹²

It should be stressed, however, that under the circumstances, it is laudable that any projects were running at all or had been identified for 1991, and running by late 1992. It is significant that a fact-finding mission representing the budgetary control committee of the European Parliament, which itself had already proved that it was not averse to strongly criticizing TACIS, came back from the FSU with a report indicating that the 1991 TACIS programme had, on the whole and all things considered, been well managed.⁹³

Even as the first 1991 projects were being launched, the basis of the 1992 TACIS programme was being drawn up. By 19 March, the 1992 Indicative Programme was signed by Alexander Shokhin and J. Ter Haar, Head of the TACIS Unit. The total grant for the CIS was 425mECU, with an additional 25mECU for the Baltics (which was later transferred to the PHARE Programme). Of the funds available to the CIS countries, 30mECU was allocated to actions in

⁹¹ 'Draft Financing Proposal. Sector Programme — FINANCIAL SERVICES', EC Commission document, 12 November 1991.

⁹² Interview with Igor Andreyevich Markov, Director of the Russian Coordinating Unit, 30 September 1992.

⁹³ *European Parliamentary Brief*, 2 November 1992.

support of specialists in the nuclear sector, including 20mECU towards the establishment of what became known as the International Science and Technology Centre. A 5mECU 'mini-budget' was also established, for small-scale unexpected expenses; furthermore, funds of approximately 12mECU were set aside for the setting-up of a coordination unit in each of the states, and a budget of 5mECU was secured for the implementation of the 1991 projects, and the programming and preparation for 1992 projects.⁹⁴ This time, the remaining balance of the budget was more precisely separated amongst the newly Independent States. The distribution of TACIS funds was done according to a weighting system dependent on population (50%), share in the industrial production of the FSU, and GNP per capita (20%); there was also significant compensation for the relatively high share of aid received by Russia in 1991.⁹⁵ Russia's share was to be 111mECU;⁹⁶ Russia could also benefit from programmes in the 70mECU regional programme.⁹⁷ Although these were the figures in the Action Programme, they were to change slightly before projects were finalized.

Having learnt some of the lessons from the identification and implementation of 1991 projects, the authors of TACIS 1992 intended to approach certain aspects differently. Part of the new emphasis was on having fewer, larger projects, thus maximizing the effect whilst reducing the bureaucratic effort involved. This was partly due to the fact that EC research had concluded that assistance from the international community had been fragmented, and should concentrate in the future on a limited number of areas.⁹⁸ Linked to this policy was the orientation towards pilot projects, which was present in choosing 1991 proposals, but was stressed even more for 1992. The triggering of a chain reaction was sought either in provoking subsequent financial operations from

⁹⁴ 'Financial Allocation for 1992 Technical Assistance Programmes to the Independent States of the Former Soviet Union', European Commission document, 24 April 1992.

⁹⁵ *TACIS Operational Guide*, (draft 6 August 1992), op. cit.

⁹⁶ 'The Delegation of the Commission of the European Communities: A Second Year in Moscow', op. cit.

⁹⁷ *Evropa*, September-October 1992, p. E14.

⁹⁸ *Bulletin of the European Community — Commission*, ECSC-EEC-EAEC (Euratom), no. 1-2, 1992, p. 79.

organizations in the EC, or rationalization in other enterprises in the CIS. The reasoning for this was partly that the Russian economy is much too large for an EC-funded project to have a direct effect on the whole, therefore the value as an example is of primary importance; also important is the fact that the command system has resulted in virtually the same conditions existing in enterprises throughout the country — the same problems, but also the same advantages; this means, in theory, that if a solution is found for one enterprise, it may well be effective all over the FSU, thus making pilot projects the ideal answer.⁹⁹

The aims of the 1992 TA programme remained much the same as those of 1991, though they were to be defined through priority focal sectors, of which there were four main ones: food production and distribution; human resources and development; networks (whether trade links, communication or energy flows between regions or republics); and business support services. To further concentrate the impact of TACIS, the Russian Indicative Programmes specified that projects in that country were to be concentrated in three regions: Central Russia, Western Siberia and the Volga region.

It was also intended that there should be much more emphasis on the interaction between various sectors. For example, if a particular region already had a project to retrain the staff of a commercial bank, and a new project was proposed in that area for the assistance of a privatized firm in its new financial self-management, the two projects would be actively encouraged to interact. Already by 1992, the Community's technical assistance was concentrating on reducing or compensating for any negative social consequences of the economic reform process. More specifically, consultancy on the creation of a more efficient social safety net was a stated aim. Also particularly emphasized in the desirability of a project in 1992 were the extent of institution building, and the downstream flow of investment.¹⁰⁰

⁹⁹ Interview with Wolfgang Kaiser, Russian CU. op. cit.

¹⁰⁰ Interview with Mr. D. Ivarsson, Russian CU. op. cit.

Within the 70mECU Regional Programme, energy again attracted most resources, especially for its nuclear projects. In fact, as the process of project identification developed, nuclear energy had its own section, using both funds originally earmarked for Regional Programmes, and funds at first intended for national programmes, amounting to 80mECU.¹⁰¹ Oil and gas were also being assisted in the Regional Programme, although more from the side of infrastructure and training; these complemented the oil and gas projects in national Programmes, for example those in Tiumen'. Telecommunications became a greater priority, and within the enterprise support services' bracket, privatization was to be particularly assisted, as was conversion of the military-industrial sector. The Regional Programme considered proposals which were made on the behalf of three or more of the CIS states, and which emphasized inter-regional or inter-state cooperation.¹⁰² Government advice projects, including some in support of the Russian government, were also included in the Regional Programme.

Within Russia, three regions specified in the Indicative Programme were narrowed down in the Action Programmes to four cities or regions: Moscow (59mECU), St Petersburg (25mECU), Tiumen' (12.5mECU) and Samara (9.5mECU). The remaining 5mECU were presumably kept aside for implementation and/or contingency costs.

Identification missions for the 1992 projects started in July. By early December 1992, all proposed projects, covering the full budget of TACIS 1992, had been approved by the Management Committee, and only final approval from the Commission was required for tendering and implementation to commence.¹⁰³

Unfortunately, this is where timing efficiency of the management of TACIS 1992 appears to have ceased. As in 1991, the contracting procedure was very slow after a project had been approved in theory. Even the 'minimum' timeframe for a project cycle provided by the Commission shows that projects

¹⁰¹ *Bulletin of the European Communities — Commission*, ECSC-EEC-EAEC (Euratom), no. 12, 1992, p. 125.

¹⁰² *Financial Allocation for 1992 Technical Assistance Programmes to the Independent States of the Former Soviet Union*; EC Commission document, 24 April 1992.

¹⁰³ According to the TACIS information bureau, Brussels, 4 December 1992.

over 300,000ECU, as they virtually all were in the 1992 Programme, could expect to take at least fifteen months before they became operative (see table 4.1). This figure was likely to be an underestimation, not least because it did not include any time for projects to be considered by the CU and forwarded to Brussels. The European Parliament's Committee for External Economic Relations passed a damning Motion for Resolution, in February 1993, which stressed the need to improve TACIS, especially speeding up procedures and decentralizing the identification and selection stages of projects; it considered that the Cooperation Councils set up by the EC-USSR Trade and Cooperation Agreement should address this problem as a priority.¹⁰⁴ Individual parliamentarians also raised this call to speed up the implementation of TACIS projects, as did the Scottish MEP David Martin in March 1993.¹⁰⁵ Delays were not limited to the setting-up of projects; there were also massive delays in the payment of EC experts. According to *The Economist*, 'the Commission's payments typically arrive from three months to a year after they are due. Consultants talk of taking it to court — but never do, for fear of losing business'.¹⁰⁶ Delays in payment are consistent with the author's own experience of work financed by TACIS.

Accusations of incompetence or inevitability of bureaucratic hold-ups are not entirely warranted, however. The major problem is that most of the responsibility for the identification and implementation of TACIS projects remains with the Commission, and that the Commission's TACIS section is chronically understaffed. By the end of 1992, TACIS had 24 'A' staff (senior, non-clerical) in Brussels; most of them on short-term contracts, rather than functionaries; this defies comparison with the IBRD, which has 400 professionals involved in projects on the CIS, whilst their projects, being less numerous and less complicated to arrange, are not as staff-intensive.¹⁰⁷

¹⁰⁴ *EP Doc. A3-0073 93*, 25 February 1993, p. 5.

¹⁰⁵ *European Parliamentary Brief*, 11 March 1993.

¹⁰⁶ *The Economist*, 10 April 1993, pp. 21-22.

¹⁰⁷ *TACIS — Annual Report from the Commission — 1991 and 1992*, op. cit., p. 45.

Thus the drive to accept only larger projects did not succeed in solving the problem of administrative workload. What it did achieve, however, is the alienation of many potential EC partners for projects. Western experts have complained that projects they tried to support were rejected because of being too small. Another problem with the large projects approved in 1992 is that they were often over-ambitious; one example was the project (under the Regional Projects' bracket) to establish business support centres, which aimed to set up eighteen such centres, whilst a consultant involved in instituting one of these centres believed that with the time and resources available, only three or four could have been initiated without compromising standards.¹⁰⁸

The identification stage of TACIS 1992 was still affected by the rapid pace of change affecting both the CUs (for the USSR and Russia), and the Commission's Moscow Delegation. The fate of the USSR CU was decided at the February 1992 conference in Moscow regrouping the eleven CIS states and Georgia with the EC, which established a new structure for cooperation. It was agreed, through the 'Protocole d'Accord', that each state should now have its own CU, headed by a National Coordinator, who should be an official of senior status. There was furthermore an attempt to establish an inter-republican coordinating body, but this proved impossible as there was too much animosity between the independent states. The EC at this stage also agreed to pay for the USSR CU for six months, until 12 August, by which time all of the states should have formed their own CUs; in the mean time, and in fact still at the end of 1993, the USSR (and later the Russian) CU has had to work from hotel rooms — at TACIS' expense.

In March a Russian CU was formed, but the USSR CU continued to exist, and although most of the respective functions of the two CUs were clearly defined, the issues of finance, accommodation and staff were all problematic. To some extent coherence was retained by Russia's National Coordinator for TACIS, Deputy Prime Minister Alexander Shokhin. In July the USSR CU was dissolved,

¹⁰⁸ Interview with Joe O'Neill, of the consultancy Trade Advisory Service, 7 February 1994.

and only one Russian CU remained, although in effect it was virtually a take-over by the staff of the USSR CU; Igor Markov became the new Director of the Russian CU. The rate of turn-over of staff was very high, and some of the Western members of the CU complained that obtaining and retaining high-calibre staff was a problem, as permission had not at that stage been granted to pay the Russian members official hard currency salaries.¹⁰⁹ The European Commission's refusal to pay adequate salaries for top quality Russian staff (whilst paying often generous fees for Western consultants) is an important problem not only within the CU, but also in TACIS projects themselves. The author has often witnessed Western consultancy companies finding it unprofitable to send their top Russian specialists on TACIS-funded projects, as it is EC/EU policy to pay no more than 150ECU per day in fees for Russian nationals; in these cases more Western consultants are used, often with less relevant experience, yet costing four to eight times the Russian's rate, and therefore spending correspondingly less time working on the project due to budget restrictions.

Although the CU could not fulfil functions such as implementation and monitoring as efficiently as it should for the 1991 or 1992 programmes, the evolution of a system, the gaining of experience and the addition of more Western experts have meant that these roles could be better fulfilled for TACIS programmes from 1993 onwards. Nevertheless, in the author's experience, Western consultants and European Commission staff tend to view the CU a a necessary evil to thin out the number of project proposals which must be processed in Brussels, and to give the Russian government a voice in the administration of the TACIS programme, but not an organization whose objectivity or efficiency can be overly relied upon.

The EC's Moscow Delegation was also in a high state of flux. It commenced operations in the spring of 1991, but only moved to a more permanent emplacement in November of that year (the Delegation moved again in late 1994, with the TACIS team then being located separately). Until the end of

¹⁰⁹ Interview with Mr. Ivarsson, Russian CU, *op. cit.*

1992, TACIS had been only a small part of the Delegation's activities, with a single member of staff devoted to it full time; the EC representation also had to deal with political relations with the whole of the CIS (representations in the other states were still in the process of being opened), with the implementation and monitoring of food aid, negotiations for further aid, promotion of EC-Russia trade, and dissemination of information about the EC. In 1991-92, contact between the CU and the Delegation had been very limited,¹¹⁰ the coordination bureau's dealings with the Commission normally being sent directly to Brussels.

Despite the extraordinary changes being faced by both these Moscow institutions, they both managed in this period to increase their input in the TACIS process. In defining the priorities for the EC's second TA operation, and defining the Indicative Programme, this time the CU had significant input. In choosing which projects to recommend to Brussels, the CU had developed a clearer approach, a better defined structure, and a more precise idea of the Commission's expectations. The CU gained the power of veto over TACIS projects, although in practice it would normally not be considered worthwhile to antagonize the Commission by using it. In some sectors (that of energy in particular) the Terms of Reference were already being drawn by the CU; in other cases, Brussels sent the TOR to the CU to be approved. Yet the feeling within the CU is that this process should continue, for example by having all Terms of References for small projects being determined by the Moscow coordination bureau. The reason for this was not only in order to shorten the delay; it was also to reduce the frustration on the part of recipients when the Terms of Reference received were significantly different from the original project suggested, as well as to reduce the dependence on over-worked decision-makers in Brussels, who in any case rarely had the same level of expertise as the experts in Moscow.

This tendency to augment the CU's competence was typified by the request for an *Emergency Fund*. Igor Markov suggested such a fund as a special measure to enable small but desperately needed projects to be implemented with a

¹¹⁰ Interview with Wolfgang Kaiser, Russian CU, op. cit.

minimum of delay. Financing from this Fund, which was proposed at 10% of the budget, could have been used in cases where both the CU and the Delegation agreed that a project met the necessary conditions.¹¹¹ Critics of such a measure were not only Eurocrats worried about unjustified expenditure, but even members of the Russian CU. One member of the coordinating bureau believed that the existing delay was often needed, for a project to be investigated properly, and that Brussels' role should be welcome, while the CU is still relatively inexperienced at implementing assistance programmes. The most important objection was that if the CU became directly responsible for the granting of large hard-currency funding, the already significant pressure from Russian Ministries to have their projects approved and to share in the decision-making would become overwhelming, and the CU's independence would most likely become restricted. In the end the proposal for the Emergency Fund was rejected by the Commission. This episode demonstrates that there is no easy to the conflicting interests of the Russian side which seeks more influence over assistance aimed its way, and the EC/EU's determination to avoid losing control over their tax-payers' money.

Partly due to the CU's suggestion, however, a new type of funding became available. Although it had not been included in the Action Programmes, by the beginning of 1993 the Commission's Delegation could approve small projects of up to 50,000ECU. The Commission did have to be informed, but only had two weeks to raise any objections. This was still not satisfactory in the eyes of the CU. The exclusion of the CU in this decision-making process contributed to the coordination bureau's criticisms, even though such small project proposals were actively encouraged from the CU by the Delegation. The size of maximum budget for such projects was the main objection expressed, as it was sufficient for little else other than conferences. It meant that business projects still had little chance of being realized before they were outdated. Nonetheless, it was a start in *empowering the Moscow bodies*, and lessening the burden of the Brussels TACIS team, and it was to be built upon in the following year.

¹¹¹ Interview with Igor Markov, op. cit.

Meanwhile, the Delegation's own capabilities to speed up the procedures for the evaluation, definition and approval of projects was increased. In early 1993, at least six new staff members were to join the TACIS section at the Delegation; by September 1994, the TACIS section had nine administrators, and six secretaries.¹¹² Although decentralization of decision-making power within TACIS is a main aim of the new policy, the new Head of TACIS at the Delegation warned that this should not be done too precipitately. Again, this is because such is the level of fear amongst some Eurocrats of accusations of public European money being misspent that this prophesy becomes self-fulfilled, due to the resulting bureaucratic hurdles to efficient distribution of project financing.

From 1993, TACIS took on a distinctly different slant, with a clear attempt at minimizing bureaucratic delays. The greatest change was in the fact that the national indicative programmes were for a three year period, valid until 31 December 1995. This meant that until 1996, the time and resources spent on indicative programmes could be used to speed up the identification and implementation stages. For regional (inter-state) programmes, the indicative programme was dispensed with altogether.¹¹³ It was expected that this decrease in administrative work would enable a decrease in the average time needed to implement projects. Perhaps because they were for such a protracted period, however, the indicative programmes were a long time in the making; they were completed only in June.

The possibility of direct project agreement, initiated with the 1992 funding, was developed further. Under the name of the *Bistro* facility (from the Russian *bystro*, meaning quickly), which was accorded 3mECU, projects of a value of up to 100,000ECU could be approved by the Delegation, with the Commission only having a week to veto any Moscow initiative.¹¹⁴ There were other differences in

¹¹² Interview with Fiona McLean, of the Moscow Delegation's TACIS Office, 16 September 1994.

¹¹³ 1993 *Technical Assistance Programme — Programme — Regional (Inter-State) Actions*, European Commission document, no date, p. 1.

¹¹⁴ *TACIS 1993 — Action Programme — Russian Federation*, European Commission document, no date, p. 61.

the approach to project identification which were aimed at quickening the pace, such as contracting out the evaluation of projects and choice of experts to outside organizations, in the case of specific sectors. This affected projects under the new democracy programme, for example, which was adopted after a Resolution by the European Parliament called on TACIS to copy PHARE in establishing separate fund for projects 'consolidating democracy and the rule of law'.¹¹⁵ Democracy Fund projects were limited to 150,000ECU, and the TACIS contribution was not to exceed 70%.¹¹⁶ Project proposals under this programme, although ultimately chosen by the Commission, were to be evaluated by the European Human Rights Foundation (EHRF), who would also monitor the progress of the chosen projects.¹¹⁷ The Regional (inter-state) Programme also introduced an identical Democracy Programme on a CIS-wide basis, worth 4mECU, and it will also contract out its management. A similar arrangement was secured for projects in the European Expertise Service (EES), the major TACIS component in 1993 for delivering policy advice to the Russian government.¹¹⁸ The Commission has hired Coopers & Lybrand to handle requests for advice from the Russian government up to a limit of 300,000ECU, and to pick the consultants to manage the approved projects. Such an approach is likely to result in more consistency than with the previous situation, when various consultants were used to evaluate TOR or project proposals. In areas not covered by special agreements such as those with the EHRF or Coopers & Lybrand, the Commission's TACIS section has made particular efforts to become increasingly self-reliant.¹¹⁹ The 1993 TACIS introduced another new element of project implementation by making project contracts open not only to EC and CIS firms, but now also those of PHARE countries, and in some cases non-EC Mediterranean countries, when

¹¹⁵ *EP Document A3-0201/93*, p. 8.

¹¹⁶ *1993 Technical Assistance Programme — Programme — Regional (Inter-State) Actions*, European Commission document, no date, Annex VIII, p. 2.

¹¹⁷ Conversations with David Geer, Manager of the EHRF's TACIS operations, February 1994.

¹¹⁸ *What is TACIS?*, Document of the European Commission's TACIS Information Office, May 1994, p. 12.

¹¹⁹ Interview with Professor Helen Wallace, 19 January 1994.

they could offer specific and relevant expertise, especially if they have experience to offer in transition to a market economy or in close links with the beneficiaries.

Also a novelty in 1993 was the inclusion of the TEMPUS Programme in TACIS, aiming to support the restructuring of educational establishments in the CIS, increasing their cooperation and links with EU academic institutions, and support the changes encouraged by other TACIS programmes. For 1993-94, the only TACIS countries to be involved were Belarus, Ukraine and Russia; in that first year, the budget was minimal, as this first phase was intended principally for the establishment of initial contacts.¹²⁰

The TACIS 1993 Programme, which for the first time included Mongolia, had an increased budget of 510mECU. As in 1992, there was a separate Regional Programme, which was granted 69mECU, and a separate and important inter-state Nuclear Programme. Regional programmes within states were treated to their own Action Programmes for the first time; there were two such programmes in Russia, for Western Siberia (27.55mECU) and the Urals (30.05mECU). Russia's federal Action Programme was catered for with a grant of 89.4mECU, bringing the total of 1993 projects for Russia (excluding inter-state projects and nuclear projects) to 147mECU.

The 1993 Regional (inter-state) Programme, as in other years, was to deal either with projects which tackle a trans-boundary problem, or joint projects consisting of similar activities being implemented in a coordinated manner in more than one state, often by the same operator. Projects of the latter type would seek to minimize costs, and ensure that projects in various states are complementary. Of the Regional Programme's eleven subsections, the largest was Transport and Telecommunications. Some of the more innovative projects included assistance with the establishment of the CIS Inter-State Bank and support for a central banking advisory service; support for twinning arrangements for know-how transfer between EU and CIS banks; and the Partnership in

¹²⁰ 'Guide spécial du candidat — Phase préparatoire du programme, année académique 1993/94 — Tempus (TACIS)', European Commission document, Task Force Human Resources, no date.

Enterprise section which expanded on the work of 1992, through the EES, and the MERCURE programme of exchange between CIS and EU Chambers of Commerce. The Regional Programme in 1993 granted greater priority to the environment than had been seen previously. The many calls for more ecological measures from the European Parliament are likely to have played a role in this development.¹²¹ The most noticeable emphasis in 1993 was on twinning. As well as the project described above on bank twinning, the Regional Programme included a section on Town Twinning, to co-finance twinings with EU towns which can share know-how in social and educational services, taxation or environmental management.¹²²

The Russian Federation's own Action Programme concerned itself mainly with projects of Federation-wide interest, with a few actions aimed at one of the four areas targeted in 1992, or ones which may be targeted in future. Following the Indicative Programme, its two main priorities were Enterprise Restructuring and Development, and Human Resource Development. Also of particular importance were Food Production, Processing and Distribution, Energy (see Appendix Two), and Networks.

As suggested above, the Russian Indicative Programme for 1993-95 provided for actions at two levels; at the federal level, and at the 'level of selected geographical concentration areas'. For 1993, this second level was provided for with Action Programmes for the Urals and Western Siberia. These Programmes, whilst maintaining the Indicative Programme's main priorities of enterprise restructuring and new social protection systems, also concentrate on solutions especially suited to their particular region.

¹²¹ See for example the Motion for Resolution passed by the Committee for External Economic Relations on 24 February 1993, which considers that greater emphasis should be put on projects dealing with environmental protection and nuclear improvements, *EP Doc. A3-0073/93*; similar calls were echoed by the French MEP Henry Chabert in May 1993 (*European Parliamentary Briefing*, 26 May 1993), and by the Portuguese MEP Carlos Pimenta in September of that year (*European Parliament Briefing*, 22 September 1993).

¹²² *1993 Technical Assistance Programme — Programme — Regional (Inter-State) Actions*, European Commission document, no date.

Despite the many improvements since the early days of TACIS, there were still many imperfections to iron out in 1993. As far as the Coordination Unit was concerned, although the division between the USSR CU and Russia had been resolved, another uncertainty had appeared. In 1993, the CU became part of the Russian Agency for International Cooperation and Development (RAICD — elaborated upon in section 4.4). Many in the CU had expressed concern about being dependent upon the RAICD for accommodation and salaries, putting them at the mercy of the strongest influences in the Russian government. The potential political role of the Agency was shown by the wranglings between the Ministries of Foreign Affairs, of Foreign Economic Relations, of Culture and of Education, which all had different objectives, and had prevented a quick defining of the RAICD's precise jurisdiction and structure. Although the EC had played a significant role in the creation of the Agency, and was hoping for positive results from its coordination role, the possibility remained that the extra degree of subordination to the Russian ministries meant the CU was even less likely to acquire any real decision-making powers.

There was a feeling in Brussels in 1993 that the CU had complained unjustifiably at the exclusion of projects suggested by it, even though the proposals had been poor in the eyes of the Commission. The impression of some consultants was that the CU was furthering projects of parties it already had links with, rather than seeking the best proposals. Although it is certain that a non-EC body such as the CU could never have the right to approve projects funded by EC taxpayers' money, the question remains open as to how much of the management of project preparation should be entrusted to this mainly Russian body. It is important to note that the harshest criticism of the CU comes from consultants whose opinions sometimes clash with those of the coordination bureau; it should also be remembered that the EU specialists in the CU could be counted upon to advise the Commission of any chronic preferential treatment which occurred in the CU. One study on external assistance reached the conclusion that 'an explicit objective of each project should be to determine how the support being provided

can be replicated on a wider scale at lower cost. In this regard, it will be vital to increase the use of local expertise'.¹²³ As explained below, by 1994 the Commission had shown that it accepted the desirability of a greater role for the CU.

As has already been mentioned, the issue of high fees being granted to those who have secured TACIS contracts is a sore point to many in Russia. Top experts managing projects can be paid up to 1,200ECU (\$1,385) per day, and very few Western consultants are paid under 450ECU per day, and this is exclusive of the re-embursable cost of flights and per diems (of 225ECU per day in Moscow and 160ECU in the regions). The Commission itself admits that 'it cannot be denied that technical assistance in some fields (privatization, banking, financial services, policy advice and so forth) commands very high prices'; it attempts to justify the costs by claiming high costs are the result of enduring assistance of high quality, and also points out that the limited number of specialists, and the great demand created by similar projects being undertaken throughout Eastern Europe, have inflated prices. 'The price of technical assistance is determined in the market place. The Commission, through tendering, ensures that the price is a significant determinant in the selection of any technical assistance'.¹²⁴

Although the services offered by top specialists in TACIS projects may not be overpriced, a more pertinent question might be the extent to which such 'top' experts are essential to the success of TACIS projects, particularly as the fields in which this 'top' expertise was proven will often not be directly applicable to Russian circumstances. Sometimes, clearly, it will be, for example when consultants involved have detailed knowledge of the fast-changing legislative and especially fiscal regulations operating in Russia, and are also able to foresee the implications for projects involving the EU. In very many cases, however, a greater role for the CU and for the European Communities' Moscow Delegation

¹²³ IBRD and RAICD, *Structural Reform in the Russian Federation: Progress, Prospects, and Priorities for External Support*, 20 April 1993.

¹²⁴ TACIS — *Annual Report from the Commission — 1991 and 1992*, Commission of the European Communities Document, COM(93)362 final, Brussels, 28 July 1993, p. 14.

(the staff of which, although having become top specialists in technical assistance, are paid very much less than the visiting experts) in determining when this is the case could greatly reduce the unit costs of projects, and increase the number of possible projects every year, despite requiring an increased management budget to increase the capacity of these two bodies. The budget for outside consultants should be lowered for all but the most demanding positions in the more complex projects (demanding in terms of high level of **pertinent** knowledge, and low number of available specialists with that expertise). A further increase in the size of the TACIS management team is required in order to give more attention to the quality of consultants and the lowest acceptable fee in any given case, without delaying the project unduly (as is often now the case). So far these savings are not being made because it is easier to use TACIS 'investment' money and pay outside consultants for such tasks which could be carried out by internal TACIS staff, rather than increase the amount labelled as 'TACIS administration' and risk facing ironic but politically damaging accusations of wasting funds instead of investing them. This paradox should be addressed, not only to leave more money for more or longer projects, but also to reduce potential Russian criticism of what is often seen as the TACIS 'gravy train'.

Another factor which has contributed to keeping project prices at a needlessly high level is the selection procedure for EC partners in projects. A first barrier to competition is the daunting registration form to join the Commission's register of consultants and experts, the only organizations to be invited to tender on large TACIS projects; it strongly favours those who have dealt with international organizations before, and who know the 'consultancy game'. More restrictive still is the commonly accepted practice of having to lobby the appropriate TACIS staff in Brussels to support particular projects; this is a practice which small organizations, or those which are less developed in public relations, can ill afford. In April 1994, the Parliament was still unsatisfied

with the Commission's management of TACIS, and requested that proposals be submitted for further suitable alterations to the Programme.¹²⁵

The TACIS programme for 1994 saw many improvements, even though the same priorities are retained, as the same Indicative Programmes remain in force. Two new geographical areas were introduced as priorities in 1994: South West Russia (Rostov, Krasnodar and Stavropol) and Kaliningrad, the EU particularly supporting Russian plans to make this area a free economic zone. There was to be no increase in the overall budget, the allocation still being of 510mECU.¹²⁶ The share going purely to Russia was of 150mECU, whilst the amount set aside for multi-country programmes was 166.2mECU. This brought the total TACIS investment for the period from 1991 to 1994 to 1,756.8mECU, with 630.9mECU having been committed to Russia individually, and Russia also receiving the lion's share of 591.2mECU committed to multi-country TACIS programmes. These are impressive figures, especially when considering that these are all non-refundable grants.

One of the major changes to have appeared is the Partnership and Coordination programme (PCP). Under PCP, projects will be financed, on a 50/50 basis by TACIS and by public and/or private sector funds from the Member States of the European Union, in partnership with an appropriate institution in the beneficiary state which must fully endorse all aspects of the project. Only projects in sectors identified in the TACIS Indicative Programmes for 1993-95 will be eligible, and all project elements to be supported by TACIS funding should be primarily concerned with the provision of technical assistance.¹²⁷ The amount of funding to be granted through PCP was initially 5mECU. This was just one of many developments which were to help TACIS delegate some of the administration of its funds (although maintaining a controlling say in the final decision-making). As well as a continuation of the Bistro (3mECU budget for

¹²⁵ *Bulletin of the European Union*, European Commission, no. 4, 1994, p. 62.

¹²⁶ *EU-CIS — Relations with the Countries of the Commonwealth of Independent States (ex-USSR)*, by the European Commission's DG X, June 1994, p. 6.

¹²⁷ From the CD-ROM network NISSWAIS — GenNetInfo: NISS BB Section: T2G9I; accessed, 5 September 1994.

1994), TEMPUS, EES, MECURE and Democracy Fund programmes which all increased de-centralization of TACIS decision-making, TACIS also increased its level of cooperation with the Business Communication Centres established in many cities in the CIS to support SMEs, as well as with the ACE (Action for Cooperation in Economics) Programme, to promote academic research and policy analysis in this field. Also jointly with PHARE, TACIS will fund the LIEN Programme (4mECU in 1994), which offers co-financing with NGOs working to support particularly deprived communities. The European Communities' Delegation in Moscow was given additional responsibilities in 1994, including the preparation of terms of references for a number of projects in each sector, and the management of consultants responsible for the implementation of programmes in the regions. The EU also had plans to open technical offices (sometimes called information offices) to support the preparation and implementation of TACIS projects, which would work jointly with the CUs but would report directly to Brussels. These centres can help the EU achieve another new goal - to administer some programmes directly through regions and municipalities, 'thus establishing a channel to strengthen reform and sustainable development at local or regional level'.¹²⁸ At the request of the European Parliament, the EU has revised tender documents for TACIS projects to underline that preferential treatment will be given to proposals which foresee sub-contracting to local companies. Another aspect of TACIS which gives more influence to Russians is the increased influence granted to local counterparts in the tendering procedures to select the experts which will operate given projects. All these modifications should improve the speed with which TACIS projects are realized, and reduce the amount of work which has to be contracted out at costs far higher than that of the staff managing the above programmes, and thus reducing the potential for this issue to keep darkening Russians' views on the desirability of EU assistance.

¹²⁸ European Commission. *TACIS Annual Report 1994*, Brussels, 18/07/95, COM(95) 349 final, pp. 8-13, 30-34, 45-47.

Arguably the most hopeful development of 1994 was the introduction by TACIS of a joint venture programme for the Russian Federation, following the success of the JOPP (Joint Venture Opportunities Phare Programme) run by PHARE. Unfortunately, contrarily to JOPP, the TACIS initiative will not offer equity funding, although it states that if the technical assistance aspect of this programme is sufficiently successful, it could expand to offer capital. This type of funding for those TACIS projects which truly would benefit from capital injections is exactly what the EU must secure, in order to make much better use of the very large amounts being used already on consultancy. It is very encouraging that such financing may soon be available.

There has even been some improvement to what is perhaps TACIS worst fault, and its least forgivable one - the failure to facilitate access to the results of completed projects. The progress and final reports of all TACIS projects should be made as widely available as possible if the effect of TACIS projects is to be maximized. These reports could not only help Russians who have not had the chance to participate in TACIS projects, but could also make future TACIS projects in similar fields avoid the many pitfalls that earlier projects fell into. In 1994, TACIS was apparently to start giving copies of these reports to the Russian counterpart, but apparently had no intention of making them available to the general public of either Russia or the EU. At the moment, to obtain such reports, special permission from the Commission and from the consultancy company involved is normally needed. This seems to be another case of putting the interests of EU consultants before those of Russian reforms. There is also no mechanism to encourage consultants about to embark on a project to become familiar with the reports of previous projects with similar aspects. Solving this problem could be relatively cheap, and bring enormous returns not only in terms of raising the efficiency of TACIS projects, but also of increasing the number of Russian entrepreneurs and policy-makers who are aware of the EU's work and benefitting from it. It is to be hoped that the distribution of these reports to the Russian counterpart is the first step in the more widespread dissemination of this

information, and that the TACIS technical centres now being planned will be used to achieve this goal.

The direction that TACIS will take in the future is beginning to be outlined. The efforts to reduce the bureaucratic work and delays in the Commission are likely to continue, both by contracting out the management of certain sectors, so that more and smaller projects can be handled, and by reducing the resources and time spent on Indicative Programmes. The degree to which the Coordination Unit and the Delegation in Moscow will be used to further simplify and speed up the management of TACIS may finally also be increasing. The likelihood of EU projects having much greater funding, and even being able to supply large scale equipment or finance, continues to be slight. There have been calls by the Parliament, for example in November 1992, to greatly increase the funding for TACIS, and even to consider an 'aid in place of arms' programme, replacing redundant arms orders in the West with commissions to produce equipment to hasten and facilitate conversion in the FSU.¹²⁹ Following an assessment of Western aid to the CIS, a similar Parliamentary Resolution was passed in April 1994, coming to the conclusion that the level of Western aid overall was insufficient.¹³⁰ There have also been repeated calls by the Parliament and its Committee for External Relations with the CIS to have access to European Investment Bank (EIB) credits, which could be used to provide capital for projects supporting TACIS aims. It seems that access to EIB funds by the CIS was supported by the Commission, but opposed by the Council, and by France and the Mediterranean states in particular.¹³¹ There is no reason to believe that the governments of the Member States are becoming any more willing to vastly increase the EU's aid budget for the FSU, nor grant a credit facility. On the other hand, as elucidated in the following section, there is a growing tendency to

¹²⁹ 'Resolution EP B3-1261/92, on relations with the CIS', *The Official Journal of the European Communities*, no. C 284, 2 November 1992.

¹³⁰ *Bulletin of the European Union*, European Commission, no. 4, 1994, p. 62.

¹³¹ For example, *EP Doc. A3-0073/93*, Motion for a Resolution, passed by the Committee for External Economic Relations, 24 February 1993, pp. 6-11.

initiate joint projects with those organizations which can supply capital, whilst the EU finances the know-how to optimize its use. This is a very positive development which is also likely to continue. The need for more resources to be spent on maximizing the effect of TACIS funding also seems to have been accepted, as indicated by the 10mECU segment of the TACIS' 1994 Multidisciplinary Programme, dedicated to fact-finding missions, feasibility studies, implementation, as well as monitoring and evaluation.¹³²

The European Community's Technical Assistance programmes have been covered in so much detail because they are the most complex, and a unique part of the EC's assistance. TACIS has changed for the better in many ways, yet still deserves much of the criticism targetted at it for being slow, wasteful and its results badly disseminated. There have also been too few resources available to ensure optimal use of available funds. Nevertheless, TACIS remains by far the largest source of grant aid to the CIS. A vast number of projects have already been implemented, at little cost to the Russian side, and with benefits which are in many cases indisputable. It is natural that those projects which have not run smoothly have attracted most attention. The EU has learnt much from its mistakes. One of the most positive changes has been to sub-contract the management of smaller projects, thus allowing smaller organizations to benefit from EU aid, and permitting these projects to be realized sooner. Reducing the amount of administrative work involved by using multi-year programmes has also been vvery effective. It should also be remembered that by its very nature, technical assistance aims at changes in the very long term, with few tangible results at first. Yet although Michael Emerson refers to the TACIS experts as 'an army spreading its way across Russia',¹³³ the amounts being invested so far still make the EU's technical assistance more comparable to pockets of resistance, often well-trained, but deprived of adequate weaponry to win a clear victory over economic and political decay.

¹³² *Bulletin of the European Union*, European Commission, no. 3, 1994, p. 71.

¹³³ Interview with Michael Emerson, op. cit.

4.4 Assistance from Other Multilateral Organizations in Relation to that of the EU

The Coordination of Western Assistance

The enormity of the problems to be solved through assistance precludes the possibility of any one organization successfully attempting to act by itself. In theory, at least since 1992, international and inter-institutional coordination of assistance has been a priority. The EC played an important role in the first international conference of assistance donors to the FSU in Washington in January 1992, and it sponsored the follow-up conference in Lisbon in May of that year; it was also a leading figure in the next conference of that series in Tokyo, October 1992. At the Tokyo meeting, it was announced that the IBRD would convene, with the participation of major donors, a consultative group on technical assistance and other matters in support of structural reform, and that Russia was ready to provide secretariat services for this group through the RAICD. The European Commission announced that it intended to work closely with the IBRD on the preparation of Country Consultative Group (CCG) meetings, and to ensure that full use was made of EC experience and expertise.¹³⁴ Several more informal meetings between the EC and IFIs have been held, some hosted by the Commission in Brussels, and some taking place amongst Moscow representatives.¹³⁵ Links have also been established between the EC and the OECD to establish a joint database.

Although bilateral aid corresponds to the greatest share of credits being offered to Russia and the other republics, coordination even among the EU

¹³⁴ *TACIS — Annual Report from the Commission — 1991 and 1992*. Commission of the European Communities Document. COM(93)362 final. Brussels. 28 July 1993. p. 38.

¹³⁵ *Ibid.*, and *TACIS 1993 — Action Programme — Russian Federation*. op. cit., p. 2.

Member States has been minimal. Even with the Twelve's bilateral technical assistance projects, the Commission has 'in general experienced some difficulty' in obtaining information on actions carried out to date with the CIS, although this information should be supplied according to Council Regulation 2157/91.¹³⁶ As far as communication between the EC/EU and the IFIs is concerned, although it has clearly improved between decision-makers, little coordinated information has been filtering through to potential consultants or business partners. The Moscow CU's manager of information technology complained that the OECD's database in Paris was very incomplete, and although the CU's database was apparently the most comprehensive in Moscow in early 1993, the poor information-sharing with bilateral aid programmes has already been noted.

The Russian government's solution to the aid collaboration problem was to establish the Russian Agency for International Coordination and Development, by Presidential decree in August 1992. The RAICD was to take over from the Ministry of Finance's Committee on Foreign Investment, the Commission on Technical Cooperation with the World Bank, and the Russian Government's Commission on International Humanitarian and Technical Assistance, as well as the more recent Russian Association of International Cooperation. The previously existing organizations had never had a significant impact. None of the documentation of Western assistance donors, nor any conversations with their representatives, have revealed any sign of these bodies having proved helpful.

The EC provided advisors to assist the Russian government in establishing this body, as it coincided with the strong desire to improve coordination which both the Commission and the Parliament had expressed regularly in 1992. The EC, the IMF, the IBRD, the British Know-How Fund and others have their own representatives at the RAICD.¹³⁷ Another important role which could be played by the RAICD, apart from assistance coordination, is to show the Russian public that Russia has some influence over the aid-granting organizations. Support was

¹³⁶ *TACIS — Annual Report from the Commission — 1991 and 1992*, op. cit., p. 39.

¹³⁷ Interview with Michael Emerson, op. cit.

also shown by the IBRD, for example through the joint publication quoted in this chapter, and through discussions in 1993 of the possibility of World Bank financial support for the Agency.¹³⁸

Nevertheless, some of the representatives of multilateral agencies had dismissed the RAICD as nothing more than a bureaucratic organ, like its predecessors. A significant factor which could hinder the activity of the Agency is the continuing disorder between the various seats of Russian power and management, and the vested interests involved. The RAICD admitted itself that it remained unclear whether it would 'be able to overcome the historical tendency for ministries to communicate only vertically', or manage to 'coordinate priorities among sectoral ministries that have a long-standing tradition of operating as self-contained entities'.¹³⁹ Another worry was that the Agency's mandate was too wide for it to concentrate adequately on any one aspect.¹⁴⁰ The CU reported in early 1993 that the RAICD did not have a computerized data system yet,¹⁴¹ and the Agency itself reported that its capacity, 'particularly in information management, remains rudimentary'.¹⁴² By the end of 1994 it seemed that all these concerns had been justified. The RAICD has shown no ability to effectively coordinate Western aid, or even to concentrate on any one area and provide detailed or useful guidance. At best it can be seen as a watch-dog, through which Russian criticism of certain aspects of Western assistance is channelled. This failure of the RAICD to coordinate Western assistance donors reinforces the importance of the EU's role in this very important and as yet undervalued field of activity.

¹³⁸ IBRD and RAICD, *Structural Reform in the Russian Federation: Progress, Prospects, and Priorities for External Support*, 20 April 1993, p. 76.

¹³⁹ IBRD and RAICD, op. cit., p. 77.

¹⁴⁰ Interview with Kovriakov, op. cit.

¹⁴¹ Interview with L. Cianforlini, responsible for information management at the CU, 26 March 1993.

¹⁴² IBRD and RAICD, op. cit., p. 77.

The European Bank for Reconstruction and Development and the World Bank

The closest relationship the EU has with an IFI is with the European Bank for Reconstruction and Development (EBRD). The EBRD is closely linked to the European Community, in origin as well as in public perception, as its concept was mooted by François Mitterrand in October 1989, during his presidency of the EC. Its realisation occurred with extraordinary speed for an IFI, as already in May 1990 an agreement to form the Bank was signed by its members, and by April 1991 the EBRD was launched in London. It was the first IFI to deal specifically with Central and Eastern Europe, as well as creating a precedent in according full membership to the Soviet Union. Another particularity of the EBRD is that the Bank's mandate specifies the promotion of democratic institutions and human rights in the countries of operation as criteria for lending, as well as stating that the Bank shall be committed to promoting environmentally sound and sustainable development.¹⁴³ All project proposals include a section on the environmental implications of the project, and the terms of lending include ecological controls where appropriate. The Americans hold the largest single stake in the bank, their holding by June 1992 amounting to 10%, but the EC member states, together with the EC's own contribution of 3% and the EIB's share of the same size, jointly hold a controlling share of 56% of the EBRD's capital.¹⁴⁴ Thus the EC/EU and its member states have the largest share of responsibility in making this organization work efficiently to support reforms in Russia and the rest of the former Eastern Bloc.

The Bank has clear principles guiding it in its choice of projects; development of the private sector; encouraging foreign investment; strengthening financial institutions; creating a modern infrastructure; improving the

¹⁴³ *Organisation*, European Bank of Reconstruction and Development, London, March 1992, p. 2.

¹⁴⁴ Karoly Okolicsanyi, 'The EBRD's First Year', *RFE/RL Research Report*, vol. 1, no. 23, 5 June 1992, p. 41.

environment, and promoting small and medium-size industry. At the EBRD's first annual meeting in April 1992, Attali proposed a restructuring facility containing a combination of soft loans (at a minimal or zero interest rate) and high-risk equity, to support desperately-needed restructuring of the Russian nuclear power industry and the conversion of its military-industrial sector. The USA, Germany, Japan and the UK all strongly opposed the soft-loan proposal, however, and it was therefore not implemented.¹⁴⁵ Yet again, a set-back for those hoping to support TACIS projects with real money to put their new knowledge into profitable practice.

Cardinal changes took place in the EBRD in 1993 following a public uproar over the large amounts spent by Attali on the new London headquarters of the Bank and on private jet travel. Another strong point of criticism was the fact that the EBRD's rate of project implementation made the EC look efficient in comparison; the Bank had only disbursed 200mECU in the whole of Eastern Europe and the FSU by March 1993, less than it had spent on setting itself up.¹⁴⁶ As a result, Attali was forced to resign, and he was eventually replaced by the former head of the French Central Bank, Jacques de Larosière.

The new President's major alteration was to abandon the division between merchant and development banking, recognizing that the separation between private and public sectors in the countries concerned was to a large extent artificial. Overall management of individual countries was to be in the hands of one person, unlike before when there was often confusion on the part of beneficiaries as to who should be addressed.¹⁴⁷ The Bank nevertheless intended to retain certain cross-border industrial teams covering sectors such as energy and telecommunications. Jacques de Larosière also appeared determined to cut operating costs, for example with the dissolution of the political department and

¹⁴⁵ Karoly Okolicsanyi, op. cit., p. 45, and Perdita Fraser, 1992, op. cit., p. 37.

¹⁴⁶ *The Guardian*, 14 April 1993.

¹⁴⁷ *Europe —The Magazine of the European Union*, (published in Washington), no. 334, March 1994, p. 16.

of the President's cabinet.¹⁴⁸ In other words, the EBRD was going through very similar restructuring as TACIS, after similar criticisms.

Like TACIS, the EBRD has progressively included more projects which were designed to manage sub-projects of much smaller scale: this was particularly needed in the case of the European Bank, as its minimum level of funding for a project is 5mECU. The first such project was for the RPFb, which also involved TACIS, as discussed below. Another project of this type was a \$7.5m (6.2mECU) co-financing line to the International Moscow Bank (60% owned by Westerners) to provide currency to enterprises in Russia. A more recent action is the 'Russian Enterprise Support Project', which is also affirmation of the high level of cooperation with the World Bank. This project offers \$300m (246.8mECU — two thirds from the IBRD, one third from the EBRD) to the Russian Ministry of Finance, which will in turn lend the capital to the twenty to thirty participating commercial banks. The project aims to acclimatize banks to offering term financing for capital investments and permanent working capital; it was to be supervised with technical assistance from the IBRD's Financial Institutions Development Project.¹⁴⁹

The EBRD's closest partner, not surprisingly considering the strong historical link and the direct shareholding involvement, is the EU. Cooperation between these two institutions was evident already in 1992, when the EBRD's determination to co-finance projects became apparent. The Bank worked together with the EC on projects to establish a wholesale food market in Moscow, as well as in the establishment of International Schools for Business in St Petersburg and Moscow.¹⁵⁰ Other such know-how projects have been assisting Moscow with its privatization programme, conducting a survey on pricing policy and food distribution, and a study of agricultural policy reform needs (also involving the IBRD, the IMF and the OECD), which was completed in March 1992. The

¹⁴⁸ *The Guardian*, 9 November 1993.

¹⁴⁹ 'Staff Appraisal Report. Russian Federation Enterprise Support Project'. IBRD, report no. 12953, 1 June 1994.

¹⁵⁰ *Evropa*, July/August 1992, and 'Sector Financial Services (1991). Sub-programme: Commercial Banks', European Commission document, no date.

EBRD also financed a technical assistance programme in aid of privatization with the IBRD, providing 35.4mECU and 72.8mECU respectively, for advisory support and training for the administrators of the denationalization programme.¹⁵¹

European Community technical assistance and EBRD equity financing were first combined for the establishment of the Russian Project Finance Bank. The EC's contribution was to be 6.7mECU, whilst that of the EBRD 2.2mECU. Whilst TACIS provided interim managers, management training, and equipment, the EBRD put forward equity, amounting to 35% of the RPFB's shares, to provide extra stability. This institution was designed at first to identify projects which should be financed by multilateral agencies and banks (as well as domestic capital), and gradually acquire the capital to take part in the financing itself. By May 1993, the RPFB was functioning, and had forty projects under examination.¹⁵²

Joint projects similar to the RPFB were also being set up on a regional basis - the Regional Venture Funds. The first such Regional Venture Fund (RVF) to be operational was the pilot Fund in Smolensk, with \$12m (9.9mECU) of EBRD venture capital and \$8m (6.6mECU) provided by TACIS for the management of the Fund, as well as for pre-investment and post-investment consultancy.¹⁵³ The first of the full-scale RVFs to be approved was for the Urals (URVF). The URVF was to be the basis for the nine remaining RVFs, with an initial 26mECU (\$30m) in venture capital, and a TACIS contribution over the ten years of the project of 17mECU (\$20m). The RVFs target medium size companies (with no more than 5,000 employees), on projects of between 260,000ECU and 2.6mECU.¹⁵⁴ In most of the RVFs, the EBRD has insisted on a 10% extra contribution of investment capital from the sub-contractors managing

¹⁵¹ 'Russian Federation. Privatisation Loan'. EBRD project proposal. 1992

¹⁵² 'Russian Federation. Russian Project Finance Bank'. EBRD project proposal. 1992; *Evropa*. September/October, 1992; *Europe*, 24 May 1993.

¹⁵³ *BEE*, 18 July 1994, p. 12; a much larger EBRD investment fund was being negotiated in 1994, worth 272mECU, to provide funding for the restructuring of newly privatized small and medium enterprises, according to the World Aid Section database, and 'Banking in Russia', a lecture given by Martin McCauley at the School of Slavonic and East European Studies. 1 March 1994.

¹⁵⁴ 'Russian Federation. Urals Regional Venture Fund', EBRD project proposal. 1994.

the Fund. e.g. Flemings has added \$3m to the URVF. bringing the total capital to be invested by this Fund up to \$33m. Not all of the RVFs' management costs are covered by TACIS; the majority of the RVFs will be run at the expense of bilateral funding, for example the Far East RVF being managed on Japanese money. These Funds work closely with the Business Support Centres which have been established by TACIS, as well as in support with the EU-backed Russian Privatization Centre. The establishment and running of the Regional Venture Funds shows that TACIS' experience can sometimes be used to good effect. Like TACIS learned to do, the EBRD used the RVFs to concentrate their efforts on certain regions, and helped reduce the bureaucratic back-log by leaving most of the project analysis to their sub-contractors, as well as to independent consultants. As with TACIS, there is much room for improvement here as well. as in practice projects have been delayed by the need for approval from the EBRD's overworked legal department, and by the lengthy approval procedure involving both the EBRD and the European Commission for the obligatory due diligences carried out by Western consultancy companies. Despite these problems, the RVFs are a good example of how the EU and the EBRD can improve each other's effectiveness by working together, and of a partial solution to the problem of TACIS know-how remaining unused due to the lack of capital.

Joint action between the World Bank and the EU, in terms of projects, has so far been very limited. TACIS 1991 included one project to establish accounting standards through the Central Bank of Russia (236,000ECU) which was co-financed by the IBRD. Admittedly, both sides had agreed on a general framework for collaboration by early 1993, and had identified specific areas for closer cooperation.¹⁵⁵ The joint efforts were to be on overall strategy, exchange of project information and draft terms of reference, joint participation in information missions and use of TACIS funds to support the IBRD's loan preparation

¹⁵⁵ IBRD and RAICD. *op. cit.*, p. 79.

activities.¹⁵⁶ The largest EU contribution to a joint project so far was the 5.5mECU share towards the Financial Institutions Development Project, the capital for which was being put forward by the IBRD and the EBRD (total investment of \$300m).

It has become clear, however, that the approach of the World Bank is often very different from that of the EU, even when trying to resolve the same problem. The most acute discord is probably in the sphere of social protection. The World Bank's perspective on the issue is naturally a reflection of the IMF's monetarist slant. An IBRD report on social protection stresses that:

the system of social protection must operate within the fiscal constraints imposed by the collapse of economic activity and the need to reduce the budget deficit. [...] Furthermore, social protection policies must support the development of an efficient labour market in Russia.¹⁵⁷

The World Bank emphasized that under the existing system, many poor received no benefits, and that aid programmes differed greatly from enterprise to enterprise and *oblast* to *oblast*. It believed that a mechanism would be needed to obtain funding from elsewhere for those mono-enterprise towns which will become bankrupt. The report argued that increases in unemployment need not be considered disastrous. Taking a social security rate 'just above minimum subsistence', it estimated that every additional one percent of unemployment would increase expenditure on unemployment benefits by less than 0.2% of GDP. What should aimed for, it suggested, was an enforceable 'austere but realistic poverty line'.¹⁵⁸

In the 1993 Action Programme for Russia, the slant was very different. Not that the EU opposes change; the Programme acknowledges that 'new structures, with accompanying managerial and financial systems, are required to take the place of the former social protection systems based on guaranteed

¹⁵⁶ European Commission, *TACIS Annual Report 1994*, op. cit., p. 13.

¹⁵⁷ 'Russia. Social Protection During Transition and Beyond'. IBRD report no. 11748-RU, 2 February 1994, p. i.

¹⁵⁸ Ibid., pp. vii-xvii.

employment and the provision of extensive services by state enterprises', and further that 'there is a need for a radically revised, well-functioning, Federal social protection system directed towards providing a safety net for the most vulnerable in society'; the EC also committed itself to 'a major project to assist the main ministries responsible for social protection in the defining of a new overall system of social protection'.¹⁵⁹

Nevertheless, the emphasis of the TACIS actions were to be 'on the optimal use of existing sources of livelihood and on existing community, enterprise and social structures'. The programme expressed the need to explore possible alternatives of maintaining the existing enterprise sector or voluntary management, this being particularly acute in respect of housing and kindergartens, which involve major assets and recurrent expenditures, hidden to a large extent by subsidies and accounting systems based on them being considered as enterprise production costs.¹⁶⁰

In many ways, this approach appears to reflect a greater realism about the existing situation. Although the maintenance of at least a basic level of social protection by the federal authorities is probably desirable, the fact is that by 1993 the Government had in large measure devolved responsibility for the administration of health, educational and social services and institutions to *oblast'* or even district level authorities. Although avoidance of unemployment is also a goal of the World Bank, the TACIS perspective shows a greater concern for the fact that the very large number of threatened mono-enterprise towns, in conjunction with the very poorly developed and expensive housing market in Russia, mean that much of the unemployment created by reforms will be very difficult to reabsorb into the workforce.¹⁶¹ With social security needs increasing whilst fiscal revenue decreases, and with much of state property (such as housing) in very poor conditions, the municipalities are often reluctant to accept

¹⁵⁹ TACIS 1993 — *Action Programme — Russian Federation*, op. cit., pp. 6 and 41.

¹⁶⁰ Ibid., p. 39.

¹⁶¹ Alan Smith, 1993, op. cit., p. 221.

responsibility, not least because of a lack of finance, structures, or trained staff to manage these resources.

On the other hand, state enterprises, having traditionally been in control of many aspects of social security, labour market management, vocational training, housing, as well as child and health care, are not always willing to abandon this interaction with workers. The enterprises continue to play a vital role in social protection not simply because the *status quo* has not had a chance to be altered, but also because enterprises have been offered tax benefits in exchange for continued responsibility over social security, for a transitional period of three years. Thus 'the ownership and control of social resources and community facilities [...] is a matter of choice, and one which appears likely to be determined by the availability of the financial means to continue their operation under arrangements for tax exemptions in lieu of transfer'. The EC paper also notes that particularly in single industry towns, links between enterprise management and municipal authorities are very close; this offers further potential for joint management of social protection. According to the EC mission which visited Moscow, the Urals and Western Siberia in 1993, 'it seems clear that substantial investment is being made by viable industries for a local and enterprise based system of social resource management, including measures to counter the threat of unemployment'.¹⁶²

Although social protection is an extreme example of policy divergence between the EU and the IBRD, it nonetheless reflects the very different priorities of both sides. Despite these different approaches, the EU nonetheless intended to study the problem of social security together with the World Bank, without committing itself to the same conclusions.

¹⁶² Draft TACIS human resources policy programme, August 1993, p. 21.

4.5 Conclusions

The West European approach to assistance to Russia has undeniably seen a complete turn around since the Cold War. From a position where trade with the Soviet Bloc was kept to a minimum and threats of embargo ever-present, gradually support for closer economic interaction became the norm. With the revolutionary reforms enacted by Gorbachev, in total contrast to the prevailing previous attitude, low levels of trade or Western investment came to be seen as a threat to Western interests. It was increasingly realized that the success of pro-democracy and free market reforms might depend on Western aid in restructuring the Russian economy, and attracting foreign partners. From the negative statecraft of trade restrictions used before *perestroika*, the EC and its allies shifted to preferential trade treatment, grants, credits and technical assistance. The abandonment of large scale trade sanctions and restrictions has been of obvious benefit to the improvement in relations and the increase in interdependence between the EU and Russia, as also explained in the last chapter.

This increased willingness to risk commercial interdependence with Moscow was much greater, on the whole, in Western Europe than the United States during the Cold War. This situation has continued to be the case, with assistance from the EC/EU being granted in larger quantities and with less conditions than that of the USA, and this has not gone unnoticed in Russia.

Nevertheless, old habits die hard, and EC/EU assistance has also remained overly self-helping and conditional. Any large assistance project must, naturally, be expected to be in the donor's interest. By having a short-term view of aid benefits, however, and tying grants to highly paid Western consultants or credits to often inappropriate Western commodities, the effect may in fact be to the donor's detriment. With the amounts of aid as small as they are, in comparison to the problems they face, everything should be done to ensure their effect is optimal; this means having less selfish and short-sighted guidelines on how the

funding may be spent. It should also be remembered that Russia's transition problems are unique, and that there are no proven solutions to her particular circumstances; the condescension of decision-makers in aid granting bodies has no justification. Even an IMF report on the Soviet economy concluded that;

Ideally, a path of restoration of graduated reform could be laid out which would minimise economic disturbance and lead to an early harvesting of the fruits of increased economic efficiency. But we know of no such path, the more particularly given the difficult starting conditions.¹⁶³

This does not mean, however, that assistance should be handed to Russia with no strings attached at all; Western supervision and auditing will in any case remain a necessity. What is needed is an approach to assistance which shares experience, responsibility and fees paid between Western and Russian specialists, with more equality and more frequency than has been occurring so far. Such an approach would help reduce some of the antagonism generated by the enormous difference between the salaries of EU-paid consultants, and of those they are trying to help. It would also help reduce the degree of cynicism towards Western consultants which has developed, and therefore reduce further the impact of some TACIS projects.

Although it is clear that conditions are very different from what they were when the Marshall Plan was carried out, and that such levels of help in today's prices are simply not realistic, it is nevertheless clear that the overall amounts of aid being offered to Russia should increase, and that the EU needs to play a leading role if this is to occur. There must be a continuation in the trend started in 1993-94, slowly appreciating that aid must be granted in order to enable market reforms to fully take place, and not as an eventual reward. This realization should be translated into much more significant amounts of aid. Amounts approaching \$20-30bn p.a., considered in the Grand Bargain, or by IMF and IBRD studies, should be the ultimate aim. Most importantly, false generosity in the form of

¹⁶³ IMF report, *op. cit.*, p. 2.

recycled aid 'packages', such as the \$24bn in 1992 or the \$43bn in 1993, should be avoided at all costs, lest the feeling of frustration and betrayal in Russia grow yet further, becoming a significant barrier in itself to the success of reforms. There a strong need for more action and less talk and study.

The EC's first direct assistance to the USSR, through food aid donations and credits for the purchase of foods and medicines was fairly well targeted, but attracted much criticism from Russians who found such aid demeaning or short-sighted. It was right that a shift occurred thereafter in the EC's aid policy, aiming instead to facilitate self-help through advice and teaching. It is unfortunate, however, that EC/EU credits did not continue to be available, to further enable those projects which needed more than a different attitude and management approach to implement the recommendations made by TACIS consultants.

TACIS is by far the EC/EU's greatest assistance contribution to Russia, and the largest know-how transfer programme offered to Russia. In the areas which it has concentrated on, TACIS is well known, and has offered the possibility to many influential people both to learn more efficient management or production methods, but also to see for themselves how their counterparts work in Western Europe. Of course, whilst earning the praise of many, TACIS has also been the target of complaints from many sources. TACIS' main weaknesses, as described in the first draft of this thesis, were largely confirmed by monitoring and evaluation missions carried out in 1994, which singled out the following changes as being necessary: decentralization; a regional approach; the introduction of new techniques; improved coordination with other donors; familiarizing experts with the new environment within which they are going to work; closer coordination with the CIS at an early stage. It also foresaw most of the recommendations made by a 1994 report prepared by the European Parliament assessing western aid to the CIS, in which the following aspects of TACIS were criticized: "the reliance on short-term experts, lack of transparency, heavy procedures, concern for specific issues including democracy, women,

environment, nuclear safety and establishing partnerships with organizations in the EU.”¹⁶⁴

Nevertheless, the size of TACIS commitments to Russia speaks for itself as an indicator of success. TACIS has also shown a healthy ability to learn, eventually, from many of its worst mistakes. Already in 1993, the bureaucratic workload was reduced by developing three-year programmes, and the effect of EU assistance was concentrated into a few geographical areas. The positive effect of geographical concentration can be confirmed by the author's work in the Urals, where most managers of large enterprises have been contacted by the TACIS Enterprise Support Centre, leaving a generally favourable impression. In 1994, TACIS improved the preparation of the experts it sends out into the field, in strengthened the CU and its relations with it, it gave Russian counterparts a greater say in the choice of experts chosen to carry out projects, and increased the likelihood of Russian companies being sub-contracted to TACIS projects. Very importantly, the EU declared that the reliance on short-term experts would be reduce, and that approval procedures would be streamlined. A further decentralization occurred in decision-making from the Commission to the Delegation in Moscow, as well as through channelling funds through the Democracy Fund, Tempus, LIEN, ACE, EES, MERCURE, and support for investment by the EBRD, the IBRD, and member states' bilateral aid programmes. The joint investment with IFIs and member states' programmes such as the British Know-How Fund is wise not only because it increased the likelihood of finding investment for TACIS projects which need the capital, but also to increase the coordinating role of the EU over assistance to Russia from around the world, a task which no other organization is carrying out satisfactorily.

Although these improvements or new goals do not solve the important problems of difficulty of access to the information obtained from TACIS projects, and of the lack of capital available to allow enterprises advised by TACIS to grow, they nevertheless make it more likely that TACIS will earn the EU much

¹⁶⁴ European Commission. *TACIS Annual Report 1994*, op. cit., pp. 9 & 13.

more praise, and much less criticism, than has been the case so far. The information and the contacts made through the TACIS programme, and the coordinating role which the EU is increasingly inheriting, make it possible for Brussels, if it can finally find the political will to do so, to lead a still badly needed international increase in the amounts of aid offered to Russia, now that the help granted so far has increased Russia's capability to efficiently absorb and put to good use larger amounts of capital. This in itself is a great achievement.

Table 4.1**TACIS Minimum Project Cycle Timeframe**

1.	Preparation for programming missions	6 weeks
2.	Programming, including submissions to Member States	8 weeks
3.	Sector/Country programme identification	6 weeks
4.	Preparation of Financing Proposals	6 weeks
5.	Translation of Financing Proposals	3 weeks
6.	Submission to Member States; evaluation	3 weeks
7.	Approval by Member States, then by Commission	3 weeks
8.	Signing of Financing Memorandum	2 weeks
9.	Preparation of tender documents (including TOR)	4 weeks
10.	Approval of TOR by recipient	6 weeks
11.	Processing and dispatch of tender documents	2 weeks
12.	Tendering period	6 weeks
13.	Tender evaluation	3 weeks
14.	Contract negotiations, award, signing	2 weeks
15.	Mobilization of experts	<u>6 weeks</u>

Total, for projects requiring tenders: 66 weeks

Total, for projects not requiring tenders: 49 weeks

[**bold** = stages not needed for projects under 300,000ECU]

Based on table in *TACIS — Annual Report from the Commission — 1991 and 1992*, Commission of the European Communities Document, COM(93)362 final, Brussels, 28 July 1993, p. 15.

Conclusions

The change in the nature of relations between Russia and the European Union in the last decade can be described without any exaggeration as both monumental and fundamental. Although the recent debate on Russia's role in Europe may be seen as a continuation of the 'Great Debate' between Westernizers and Slavophiles, both the issues being addressed and the very approach to the debate have shown unprecedented similarity with the West.

The shift back towards closer relations with Western Europe in the last quarter of this century is all the more remarkable when compared to previously high levels of animosity and mistrust not only towards the main EC member states, but also considering the fears concerning the perceived role of the USA in Western Europe. Nonetheless, the late 1980s saw closer liaison with Brussels becoming one of Moscow's main priorities. Greater political interaction began to be sought, both to enable greater economic integration with the West, and to gain support from a visionary 'return' to Europe. In a very short time, all the previous deadlocks to agreement with the EC from the Soviet side were abandoned. Such was the pro-European slant of Gorbachev's government that it was willing to largely accept Brussels' terms.

This desire to be more closely integrated with Western Europe was by no means simply a temporary pipe dream of peace and cooperation throughout the European continent; it was a pragmatic attempt to use demilitarization and closer commercial interaction with the West to save the USSR's withering economy. This is a factor which no wave of populist nationalism will be able to ignore. The loss of the East European buffer zone; the established precedents of freedom of expression and of embryonic democracy; the increasing presence of modern communications equipment linking Russia to the rest of the world; the inevitable

interdependence of modern economies — all these factors and more mean that Russia can no longer realistically be isolated from Europe.

The fact that Russia no longer wants to be isolated in security terms either is also of potential importance to relations with the EU. The definition of 'security' has broadened, to include risks such as mass migration and environmental disasters; for both of these security challenges, Russia has been receiving EU assistance through TACIS. Russia is likely to look to the EU for support in establishing a new European security structure, whether based on the OSCE or a new organization, as an antidote to a NATO-based structure.

Admittedly, a very great resentment and frustration towards the West has also emerged, and disillusionment with Europe in particular is strongly felt. The so-called 'Zhirinovskii factor' represents a pendulum movement, swinging back towards a tendency for increasingly pro-Slavophile policies. This discontent is most extreme in the nationalist press, but it has come to be reflected, more moderately, in government policy also. Frustration has been expressed not only about the failure to fully open up Western markets to Russian exports, but also about the lack of progress in establishing a European security structure acceptable to all. Linked to this bone of contention is the feeling that Russia is being humiliated and exploited by the international community, rather than effectively helped yet respected as an equal.

Whilst the complaining and resentment continues, however, in the pages of populist news-sheets, in the statements of army representatives and born-again Communists, the Russian government has not abolished the laws which allow EU and other Western business people to trade with Russia and to invest in its future. Those who wield economic power, and therefore usually political influence also, are not overly vociferous in Russia, as too much attention can be unhealthy. However, if they were to feel that their prosperity was being put at risk, they will find ways to 'convince' authorities at almost any level to allow business to proceed as usual. Even for the average person on the street, there is much to lose: the Russian retail sector is now full of EU commodities, the Russian media are

inundated with Western material, and travel abroad has never been so easy. Freedom of choice, movement and of speech are not going to be given up easily by the Russian public. The popularity of Liberal Democrats and Communists will only continue to be significant as long as they do not seriously threaten the above achievements of the Westernizers. In the same way, it is unlikely that the improved political and commercial relations with the EU would be allowed to be entirely squandered, regardless of any election results. Because of the need to modernize its industrial base, to allow its entrepreneurs to travel and trade freely, to satisfy the now Westernized tastes of its population, or to avoid being isolated from the political and security developments in Europe as a whole, Russia can simply not afford to cut itself off from the EU anymore.

After the protracted and fruitless attempts of the EC to establish relations with the individual CMEA countries, the reversal of Soviet policy towards one of cooperation was a great victory for Brussels' position of strength. In retrospect, it could be argued that it was detrimental for the Community to become acclimatized to winning its own way, with few sacrifices. Nevertheless, it became clear that Moscow was being forced for economic reasons to compromise with Brussels, and that the EC's upper hand was being recognized.

The first Agreement of Trade and Cooperation between the EC and the USSR was achieved remarkably quickly, due to the political priority it received from both sides at that time. Again, after the precedent of the original Helsinki Conference, Brussels had been able to use relations with Russia as an instrument to build its political prestige and diplomatic role. Yet the beginning of negotiations for the Partnership and Cooperation Agreement, just over two years after the Trade Agreement, showed that there was much still to be achieved. The main complaints were in the economic sphere, directed especially towards the fact that anti-dumping measures remained particularly easy to introduce against former Communist countries. Again, the Twelve's advantage was clear, and again, the author would argue that it was to some extent abused.

The signing of the Partnership and Cooperation Agreement, for all the shortcomings of this accord, is nonetheless a momentous step forward in the pursuit of united and peaceful Europe. It is important that Russia became classified as an 'economy in transition' in the Partnership Agreement, although it is also telling that Russia was not granted assurances for its exports of non-ferrous metals, nuclear fuels, textiles or satellite services. On the political front, the biannual summit meetings which have been institutionalized are a historic step forwards, but the most consequential part of the new Agreement could prove to be the explicit aim of establishing a free trade area joining Russia and the EU. However, if this free trade area becomes reality at all, it now seems likely that it would still limit the benefits to those areas of trade where EU producers have nothing to lose, Russia thus not having much to gain by this grand-sounding scheme. It could very possibly become another opportunity wasted by the EU for increased economic interdependence with Russia, unless Russia is sufficiently encouraged through trade concessions to emulate many of the processes of economic integration which have been achieved through the establishment of the European Economic Area between the EU and EFTA.

The 1993-94 period brought a fall in the level of Russian cooperation with the EU, as shown by tougher negotiations over the Partnership Agreement. Despite this, Brussels has remained very positive and amiable towards Moscow, even after such undemocratic events as the shelling of the White House. Events such as these showed clearly that the Twelve are ready to forgive a great deal before they initiate any move which would put the *rapprochement* with Russia at risk.

The EU's role in promoting a European security structure which would be agreeable to Russia is not limited to the reduction of threats to security from the dangers of environmental degradation and economic migration. In terms of the military aspects of European security, although the WEU will not be an appropriate body for Russia, the EU may be able to push for other solutions. Although NATO is the only organization which has shown the solidity to try to

link up Eastern Europe and the FSU into one security body, and despite Russia's acceptance of the Partnership for Peace, NATO's history and American domination make it a very improbable vehicle for any truly active participation on Russia's part, as it could not be treated as an equal. A more all-embracing security structure would be more likely to be possible if based on the OSCE. The OSCE, whilst being a well-established international organization, and already having the right to call for the mobilization of the WEU and NATO forces, does not have the Atlanticist domination which NATO commands. It could also easily incorporate environmental policing, as well as continuing its human rights monitoring. The EU could play a central role in encouraging, and then enacting, such a restructuring of the OSCE, if only Russia itself could set a better example by translating its theoretical support for a greater role for the OSCE into practical support for missions in the FSU.

All in all, the EC/EU has moved quickly to offer support to the USSR/Russia in its period of transformation, and the Partnership Agreement is a very important achievement. The EU has shown great restraint in the face of occasional slights from Moscow, and it is clear that maintaining friendly terms with Russia is a very high priority. Although the possibility of building a new security structure which included Russia receded as the Chechen crisis started, and the protectionist forces (which affect Russia) within the EU were not weakening, the fact remains that the EU is determined to make the political aspects of the Partnership Agreement work, and to keep increasing trade and investment with Russia, if not necessarily through a free trade area before the year 2000.

The further development and deepening of relations between the EU and Russia will depend, to a large degree, on the levels of trade and investment flowing between both sides, and the lobbying pressures thus generated. In particular, it will also depend on what Russia has to lose by not maintaining good commercial relations with Western Europe. It is clear that imports from the EC have

traditionally been of particular significance to the Soviet economy, and that this importance has grown still further in the first half of the 1990s, with the importance of exports to Western Europe being equally essential in order to fund the inflow of technology and consumer goods. Such was the legacy of the Soviet command economy. The price for the lack of access to Western technology and information, for the isolation from worldwide supply and demand, is still being paid.

Many of the factors which prevented Soviet production from being competitive, or which made Western involvement virtually impossible, were successfully tackled since 1985. As a result of *perestroika*, EC entrepreneurs could invest in JVs, set up wholly owned subsidiaries, and sell their goods for hard currency, whilst traders could deal with individual companies rather than state bodies. El'tsin pushed the reforms further, to the point where Russia could at least begin to compete with other countries to attract investment or increase its market share. The privatization process became accessible to EU investors, and helped everyone to comprehend better the value and management of Russian companies. The ruble could now be freely converted within Russia, meaning that there was no longer any need to look only to export from Russia in order to obtain worthwhile profits. Just as important is the fact that those profits, once exchanged for hard currency, could now be repatriated, as long as this was done by registered foreign investors. Prices had finally started reflecting real supply and demand, so that in a surprisingly short time the Russian workforce no longer had to extend its lunch-breaks or shorten its working days in order to get a place in the queue; by 1994, even inflation had become more or less manageable. This does not mean that all the problems have been solved, and that it is now only a matter of time before large-scale investment from the EU starts flooding into Russia. The telecommunications, transport and tourist infrastructure are all hindering greater trade and investment with the West, although not nearly as much as the legal and especially fiscal chaos, both in terms of regulations and implementation; nor are these factors as damaging as the political conflicts

between pro- and anti-reformers, and between the centre, regions and municipalities.

Still trade continues with the EU — in fact it keeps growing, just as investment does. In terms of trade, already the rules of the game are becoming more predictable, and the assistance of banks can be counted upon increasingly. Already there is a shift of investment from Central and Eastern Europe to Russia, and this flow of investment will increase vastly if the political and legislative instability and unpredictability can be reduced. The relative stability of late 1993 and early 1994, for example, together with the conciliatory abilities of Prime Minister Chernomyrdin, was all it took to obtain a considerable increase in foreign investment in the summer of 1994. There is a large number of very expensive projects which are just waiting for the level of political risk to settle. Whenever this boom in investment does take place, the Russian government will have all the more reason to avoid antagonizing the EU.

Although, in terms of influence on Russian governmental policies, Western aid has been far from an unmitigated success, it nonetheless remains a crucial part of relations between the EU and Russia. Although the EC has traditionally had little statecraft influence on Russia, this situation is being reversed, partly due to TACIS, partly because of the increasing importance of non-oil and gas exports from Russia, and partly because of the influence of the EU in bodies such as the G7, IMF, IBRD, and GATT. The EC's technical assistance has been the largest example of non-refundable aid, and of know-how transfer to Russia. TACIS has provided many good examples of how to encourage long-term self-dependence and avoid corruption, although there do remain many aspects of the EU's aid which need to be improved. There needs to be a greater number of well-trained EU staff to identify, manage and monitor projects, in order to limit the contracting of prohibitively priced consultants in project management; communications and relations should also be improved between the staff in the Moscow Coordination Unit, the Moscow Delegation TACIS section, and the TACIS section of the

Commission. The ability to put TACIS' know-how into practice should also be a greater priority, both by increasing the proportion of projects' budgets which can be used for equipment, and ultimately by providing credits as well as expertise, possibly through the European Investment Bank. Perhaps most importantly, the massive amount of useful information which TACIS programmes have created should be made much more readily available, rather than allowing consultants to repeat the same costly studies. All in all, however, despite the fact that a certain amount of resentment has grown towards consultants who have come on TACIS projects with much advice but no hard financial investment, and despite the other failings mentioned above, TACIS programmes have provided good information and good examples to a very large number of greatly influential people, and the impact of these projects will continue to grow as this knowledge is passed on. There were particularly encouraging changes recently in relations with the Russian Coordination Unit; increased usage of TACIS' own staff and less use of short-term consultants; better preparation of consultants before they start work on a project; making tendering and contracting procedures easier to use; finally operating independent monitoring and evaluation visits; and increasing decentralization of decision-making from Brussels to Moscow. This left only two major deficiencies to be rectified: the lack of easy accessibility to the reports resulting from TACIS projects; and the lack of funding available to follow up on TACIS restructuring recommendations. All in all, it appears that this relatively successful aid programme will continue to improve, as will its effect on the Russian's goodwill towards the EU.

A growing number of projects now combine TACIS know-how and EBRD or IBRD credits, which is to be welcomed. These joint projects show that there have been improvements in the coordination of Western assistance, although the sharing of information and experience remains inadequate, especially with regard to companies and consultants seeking the optimal approach to new projects. Most importantly, it is to be hoped that this cooperation between TACIS and IFIs will allow a more large-scale financing of projects which would allow Russian

entrepreneurs to maximize the benefits of new approaches and technologies brought to their attention by EU-funded consultants.

Aid levels have not only been too low to have a sufficiently tangible impact, they have also been insufficiently focused. Further investment should be project-related, as the EBRD and IBRD have been offering, but on a much larger scale. Some of the areas on which TACIS has been working need to be high priority areas for overall Western aid, especially nuclear safety, which is already being tackled in earnest, SME development funds and a programme of social security development and support. The regional concentration achieved successfully by TACIS should be emulated by other donor agencies.

The predicted backlash, in the case of insufficient support to prevent a harsh fall in living standards, has now arrived. Yet the shift away from unambiguously pro-Western policies and the disillusionment with Western assistance does not mean that these elements no longer have a role. Many of the reforms are likely to be irreversible, as long as total civil breakdown can be avoided. In fact, it was always known that the seeds of individual entrepreneurship sown by economic reforms would take a long time to truly flourish and make a difference. Western assistance still has a vital role to play in encouraging a continuation of the move towards a free economy and society, even if at a pace slower than was originally hoped. It is just as well that Michael Emerson believes the EU's contributions must be cooperative and patient, and that 'the European Union sees itself as a steady, long-term partner of Russia, not one quickly inclined to blow hot or cold'.¹ Although the TACIS component of EU assistance *per se* cannot be expected to represent significant leverage over Russian policy for Brussels, when taken together with the EU states' contribution to the credits made available through the EBRD, the IMF and the IBRD, the overall aid to Russia clearly has significant statecraft value, and will have even more as the amount of aid increases.

¹ Ibid., p. 14.

Aid, of course, can only be a short-term solution. Russia needs to be allowed to trade freely with the EU, at first perhaps even at a relative advantage, for economic development to best ensure its progress towards democracy. The need to integrate Russia with the rest of Europe, both economically and in terms of a security structure, is not simply one of material and strategic interest to Western Europe — it is a case of historical perspective and mission, something of which the governments of present-day Europe are proving themselves in short supply. The 1990s have provided a truly historic opportunity for the EU to lead the way in re-unifying Europe, and recover from the ravages of the Cold War and Soviet imperialism.² The need to build a New Europe is far too important for the EU simply to protect those who are already a part of it.³ Although there is no question of offering full EU membership to Russia, the European Union nonetheless has the possibility, even the responsibility, to draw Russia into mutually beneficial and therefore long-lasting economic and political structures which could help ensure a peaceful future for the New Europe.

Despite the fact that the pace of change could have been faster, or the amount of aid and the openness of the EU market made greater, the successes of the EU's relations with Russia outweigh the failures. The closer political dialogue between Brussels and Moscow; the much freer travel between Russia and EU states, especially for Russians; the possibility to avoid being locked out of a 'Fortress Europe'; the need for EU goods, technology and investment; the support of EU states in other multinational organizations; the aid through know-how and credits being offered by the EU and other organizations uniting EU member states; the freedom of expression, choice and lifestyle acquired under the reformers — all of these factors, and many more minor ones enumerated in this thesis, outweigh the factors which have pushed the Slavophile influence to prominence again in the last few years. As Heinrich Vogel writes:

² J. M. C. Rollo and Helen Wallace, 'New Patterns of Partnership', in *The Community and the Emerging European Democracies*, a Joint Policy Report of six national EC foreign policy research institutes, June 1991, p. 55.

³ Michalski and Wallace, *op. cit.*, p. 3.

The limits to the re-embrace of the foreign policy perceptions of the Soviet era will probably be reached when these clash with the irreversibly commuted basics of a Russian society that is more open in terms of its economic and information expectations, i.e. when they come up against the interests of the new economic elites and of society as a whole.⁴

The undisputable hardship brought to many under the economic reforms, the frustration of the army and former Communists who have no lucrative management post in a privatized company, the anger at the loss of pride since the collapse of the USSR — all these issues are potent, and will always allow those opposed to reforms to have a strong voice, but not to turn back the clock to pre-*perestroika* days. The many advantages which have emerged from the *sblizhenie* with the EU, and the many benefits to be obtained by Russia from a still closer relationship, will ensure that the two sides of Europe do not become isolated from each other again, at least for the foreseeable future.

⁴ Heinrich Vogel, 'Russland als Partner der europäischen Politik', *Berichte des Bundesinstituts für ostwissenschaftliche und internationale Studien*, no. 8, 1996, p. 55.

Postscriptum

A great deal has happened between the end of 1994 and the second submission of this thesis in June 1996 to significantly affect relations between Russia and the European Union. The most well-publicized and influential event has undeniably been the continuation of the war in Chechnia. The fact that armed intervention of this scale occurred at all is a clear indication of the reduction in respect for West European standards of conduct in general, and of the expectations of the EU in particular, which had been occurring since 1992. The EU reacted relatively harshly at first, more so than the USA, by postponing the signature of the Interim Trade Agreement (which was to enact the commercial aspects of the Partnership and Trade Agreement, pending the ratification of this Agreement by national parliaments of all countries involved) until the situation improved; France also threatened economic sanctions. At around the same time, the Council of Europe put Russia's application on ice.

These were the only significant West European actions taken against Russia over the intervention in Chechnia, despite much public criticism of the manner in which this crisis was handled by Moscow. The EU member states and their allies were happy to hide behind the pretext of Chechnia being an 'internal matter', in order to avoid a showdown which would have destroyed most if not all of the positive effects of the political agreements, trade advantages and assistance programmes carried out in the last decade. In other words, despite the bloody conflict in the Caucasus, the EU and its member states continued the 'support at virtually any cost' policy which they had already demonstrated earlier, and which was depicted in Chapter Two.

This determination to remain on as positive terms with Russia as possible was shown even more clearly by the decision at the Cannes European Council Summit in June 1995 to go ahead and sign the Interim Agreement with Russia,

thus enacting the commercial aspects of the Partnership and Trade Agreement, as mentioned above. This turn-around occurred, despite a continuation in hostilities, because Russia had agreed to start negotiations with the Chechen pro-independence forces, and because Moscow had agreed to permit an OSCE delegation to visit Chechnia, and eventually to open a representative office to monitor the conflict (despite many restrictions and interferences being imposed upon this delegation, including virtual house arrest at one point). In the words of the then British Foreign Secretary Douglas Hurd, speaking as a member of the European Council: 'We have for the first time made a link between the OSCE mission and future relations with Russia'.¹ This development was of enormous importance not merely as an indicator of a greater willingness within the EU to grant a serious role to the OSCE, but most importantly Moscow's acceptance of this condition showed that, despite pressure from anti-Western forces both in opposition and among his own supporters, El'tsin was still ready to react to EU pressure.

The signing of the Interim Agreement was not the only positive development in Russia-West European relations during this period. As noted in Chapter Two, Russia also finally consented to sign two agreements which enacted the most important aspects of the PFP agreement with NATO. Although this move did not mean a greater acceptance in Moscow of the possibility of NATO expansion into Central Europe, it was an important step towards Russia trying to resolve objections it has to the policies of the rest of Europe and its allies from within Western structures, rather than from without. Another historic development over the last eighteen months, and also despite the on-going bloodshed in Chechnia, was that the Parliamentary Assembly of the Council of Europe finally approved Russian membership of the Council of Europe, albeit for an initial probationary period, despite the fact that Russian legislation in many areas remained incompatible with Council of Europe membership — notably in the continued usage of the death penalty. Yet again, West Europeans showed that

¹ *The Guardian*, 24 January 1995.

they were more concerned about not worsening the cooling but still workable relationship with El'tsin than about European standards being followed faultlessly by Moscow. Although turning a blind eye to violations of mutually-agreed standards in this way is likely to cause some confusion and over-estimation of acceptable practices by Russian decision-makers,² it does show Russia that Western Europe is also willing to compromise in order to bring Russia closer to the rest of the continent, and that its presence is important.

Western support has also extended to the financial sphere (although we have seen that this cannot be separated from the political situation). Despite many ups and downs of the Russian economy over this period, all in all it demonstrated at last a capability to stabilize the macroeconomic situation, and thus also to maintain the ruble pegged within certain boundaries. Even whilst these successes were only plans, the IMF approved in April 1995 what was then its second largest stand-by loan worth \$6.8bn. In February of the following year, despite on-going concerns about Russia's ability to stay within the strict budget deficit boundaries specified by the IMF, the Fund announced a \$10.2bn three-year loan to Russia. This measure was a clear message of support for El'tsin, as well as a very tangible carrot which would be taken away if Boris Nikolaevich or his successor after the June 1996 elections stray away from the policies of privatization, macrostabilization and free market relations which have been achieved so far. It is also significant that the EBRD's capital was agreed to be doubled to 20bnECU at the AGM in Sofia in April 1996, with a greater proportion of this capital going to Russia and the rest of the CIS, as the economies of Central Europe strengthen their post-Communist recoveries. Most directly relevant to the EU, TACIS also decided in 1996 that its programmes would continue into 1997 and beyond.

All the above developments do not hide the fact that there is a risk of Russia falling back into isolation and a confrontational relationship with Western Europe. Apart from Chechnia, Russia's refusal to ratify START II without

² Heinrich Vogel, *op. cit.*, p. 57.

significant alterations, and its increasingly independent and often uncooperative stance in international diplomacy also give cause for worry. The very strong electoral results of the Communists and of the Liberal Democrats in the December 1995 Federal Duma elections, and the majority predicted for Gennadii Ziuganov in the presidential elections up to one month before them — until El'tsin's huge and monopolistic electoral campaign fully got under way — all justify fears that there could be mass support for policies which alienated the EU from Russia. One possible scenario could be for Ziuganov to win the presidential elections, for increased payments to pensioners, the army and the state sector to cause hyperinflation again, followed by a re-centralization of price controls over at least essential foodstuffs, fuels and essential industrial raw materials. This could be accompanied by a partial re-nationalization, and new restrictions over foreign ownership and management of enterprises, especially in energy and other raw materials. These measures would result in the exodus of the vast majority of Western investors, as well as all assistance projects and credit offers. Trade restrictions on Russian goods would again be increased due to the artificiality of prices (and, most likely, to higher import restrictions being brought in by the Communist Party), and not only would any hopes of a free trade area with the EU would be lost, but many of the trade aspects of the Partnership Agreement would have to be reversed. The antagonism caused by these trade conflicts would very possibly lead to an even more bullish Russian foreign policy, which would renew the mutual distrust and usual confrontations at international diplomatic meetings which characterized relations between the USSR and the EC before Gorbachev. Most of the progress of the last decade would have been lost.

The above scenario is possible, but it is extremely unlikely. This is not only because it now appears that the huge lobbying power behind El'tsin, and his control of the main television channels, will secure another presidential term for him. Even with a Communist victory at the presidential elections, the shift of power which has occurred in Russian society towards those with control over large enterprises and over exports and imports would most likely mean a period of

severe instability whilst alliances were re-aligned, following which the lobbying power of the richest Russians, most of them from the previous Communist *nomenklatura* in any case, would ensure that the new President's policies would not do too much damage to their business interests. Although a higher level of inflation and devaluation of the ruble would almost certainly occur, the RCB would be persuaded to minimize damages, and the success of economic reforms would be slowed down rather than dissolved. Even in the unlikely case of the large industrialists and exporters allowing the economic situation to deteriorate to the point where relatively open trading with Europe is threatened, this position would be only temporary. As explained in Chapter One, the freedom of choice and of expression which has been tasted by the Russian population in the last decade, and especially enjoyed and adopted by the young people, will not be abandoned. Any denial of the freedom of choice, of enterprise and of trade, will sooner rather than later collapse in the face of the inevitable attempts throughout Russia to find a way around new rules, and to use the increased global communications to return to the open society which Gorbachev and El'tsin allowed them to enjoy.

It is difficult to say when the point of no return was reached; it could have been when the masses changed the destiny of their country (or at least thought they did, which is what matters) in August 1991, or it may have been the gradual affect of being able to buy without queuing, to speak without fearing, and to travel without dreaming. In any case, it is the author's firm belief that close relations between Russia and the European Union, although not necessarily without periods of struggle or restricted trade and contacts, will on the whole and in the medium-term at the latest continue to strengthen, and allow Russians to be ever more justified when they think of themselves as Europeans.

Appendix 1: Aeronautics as an Example of the Potential for Increased Commercial Interaction with Western Europe

A1.1 Importance of Sector

Aeronautics, together with the oil and gas industry, has been targeted in this study as it is generally considered to be one of the more promising areas in which Russia can exploit a relative advantage in the world market. A closer look at the industry is intended to enable the reader to form a clearer understanding of how the theoretical opportunities, risks and uncertainties of dealing commercially with Russia covered in chapter three are being tackled in practice. The picture is inevitably incomplete and to some degree inaccurate. This is in part because many new projects and deals will have been concluded since the time of writing, and in part because the specialist journals are certain to have missed many projects, not least because many companies want to keep their formulae for business success in Russia secret. This very reluctance to disclose the tentative solutions being tried by Western importers and investors reflects the value of this information, however: as suggested earlier, precedents are still more important than legislation in Russian business today.

In aeronautics, Russian enterprises' attempts at breaking into the international market must be put into the context of a global slump in aircraft sales. Due both to the overall recession, and in particular to the global tendency to reduce military budgets, most of the major Western aeronautics enterprises have been reporting decreased orders, leading to large-scale lay-offs. For example, the best-selling aircraft producer in the world, Boeing, intended to decrease its output from forty aircraft a month in 1992 to twenty-five per month in 1994.¹ Within Russia as well, the freeing of prices and removal of subsidies

¹ Presentation by Børge Boerskov, Vice-President of European Sales for Boeing, at the 'Development of a Modern Air Transport Industry in the CIS' Conference, 13 May 1993.

have led to a fall in demand for air transport. In the first quarter of 1993, Russian domestic air travel fell by over 40%, with only 7.1 million passengers flying compared to 12.1 million over the same period in 1992, as prices increased by up to eight times after the liberalization of airline ticket prices on 1 January 1993.² This clearly dampens the prospects for domestic sales of new aircraft until the economic situation improves, despite the immense potential offered by the sheer vastness of Russia, the size of its population, and the established precedent of large-scale use of air transport.

Another potential disadvantage of having aeronautics as a priority growth sector is its military slant, particularly in Russia. Apart from the diplomatic problems involved in relying on exports of military hardware, encouraging the military-industrial complex to continue producing military aircraft, even possibly increasing its power through massive hard currency earnings, could well prove to have an unhealthy effect on economic reforms overall. An increase in financial clout of the military industrial complex could weaken the position of internationally-minded reformers.

On the other hand, a well-supported commercialization programme for the aircraft industries is likely to be the quickest and most efficient method of converting them to civilian production, especially if opportunities to sell military aircraft prove to be limited in practice as well as in theory. The capital available in conversion funds, and more importantly the political priority that conversion has been holding with El'tsin's government, could also be factors attractive to potential foreign investors in civilian aeronautics. There are furthermore signs that despite the aviation industry's present slump, the longer term perspectives may be more promising. According to the Chairman of the Aerostar Aviation Complex, a 60% increase in air passenger traffic is expected by the year 2,000, most of all in the Asia/Pacific region, creating the perfect opportunity for a boom in the CIS aerospace sector, because of its geographical proximity, established trade relations in aircraft with many Asian countries, and a specialization in

² *Moscow Times*, 20 April 1993

slightly more down-market planes.³ Also encouraging is the fact that despite the decrease in the volume of air transport in Russia in early 1993, for the first time the airline industry came close to breaking even, with Russian domestic and international airlines having a total income of Rb177bn, for outgoings of Rb180bn.⁴

For the Western aeronautics industry, however, the mere fact of being able to closely inspect most aspects of former Soviet aeronautics is attractive. The overall Russian movement towards greater integration into the world economy (as described in chapter one) has naturally included aeronautics, meaning that a very high standard of technology, which has been for so long shrouded in mystery, has suddenly become largely open to scrutiny, and sometimes cooperation. As a result, every major Western aeronautics manufacturer has been sending representatives to Russia, to investigate the possibility of sales, and even joint production. The appearance of a large number of Russian aircraft at the Le Bourget and Farnborough Airshows, starting in 1991-92, including many planes which had never been seen in the West before, attracted an enormous amount of attention. Perhaps the clearest confirmation of the opening of the former Soviet aeronautics industry came in August 1992, with the MosAeroshow, displaying to guests from around the world 114 types of aircraft, many previously unseen, as well as previously undisclosed radar and missile technology. In the words of one French military attaché 'five minutes at this show teaches us more than twenty-five years of espionage'.⁵ Those few companies who had already prepared or even signed deals with Soviet aircraft producing enterprises before the USSR's collapse have been finding the rest of the aeronautics world right behind them, hunting for the best way to translate Russian technology into profits.

The many aspects of Russian aeronautical involvement with foreign countries worth investigating have here been divided into the following

³ Presentation by Vladimir Mikhailov, Chairman and Executive Director of the Aerostar Aviation Complex, at the 'Development of a Modern Air Transport Industry in the CIS' Conference, 14 May 1993.

⁴ *Moscow Times*, 20 April 1993.

⁵ *Air & Cosmos / Aviation Magazine*, no. 1389, 31 August-6 September 1992.

categories: i) purely Russian military aeronautics export potential; ii) conversion and restructuring of Russian aeronautics enterprises; iii) purely Russian civil aviation export and leasing projects; iv) partnerships with Western enterprises, amalgamating Russian and Western hardware; v) joint production partnerships with Western enterprises, and the most marketable areas of Russian expertise; vi) the purchasing and leasing of Western aircraft in Russia. This appendix starts with military export potential because this is still the most lucrative earner in the short-term, the models being tried and tested, and well-established relations with many purchasers having been secured. Nonetheless, the future of the aeronautics industry lies in the civilian sector, as does that of the Russian economy as a whole, and hence the importance of the conversion of many of the military aircraft producing enterprises. The process of privatization is also particularly vital in the sector as a whole (not merely for enterprises turning away from military production), both for the competitiveness of Russian aeronautics enterprises on the global market, and to facilitate involvement with Western partners. On the civilian side, firstly those export and leasing projects which do not involve an important contribution from Western partners are examined, as they are either concluded, or at least nearer to fruition than most joint ventures with Western partners. The following section covers the most common type of cooperation between Russia and the West in this industry so far, namely the coupling of equipment from both sides to make an attractive package, both for export and for domestic demand. This is followed by information on projects of joint research or production of aircraft components, which are less numerous and well-developed, but are incessantly increasing. Here the reader will also find areas of specific Russian expertise where cooperation with Western firms has not yet been secured, but may well be soon. Finally the other side of the free-trade coin is studied, that is the new competition with Western aircraft producers in the Russian market, in other words the standard which the Russian aeronautics industry must reach if it is to survive.

Cases used will include not only those involving West European enterprises, in order to obtain as wide and accurate as possible a view on the potential for greater involvement of Russian aeronautics enterprises in the world market. A precedent set by a North American investor is likely to be as useful to an EU aircraft manufacturer as one established by a European competitor.

A1.2 Military Aviation Export Potential

Exporting planes is by no means a new phenomenon for Russia; for decades before *perestroika*, Moscow had sold aircraft to its socialist allies and to Third World countries where it wanted influence.⁶ The potential for military aviation exports is included here for the following reasons: a) EU member states have considered purchasing Russian military aircraft; b) the worldwide revenue received from selling military aircraft may find its way into supporting Russian civilian aeronautics projects which could attract EU investments and find an export market; c) the technological advantages of Russian military aircraft are often found also in the civilian craft, although their disadvantages also tend to be shared.

The new readiness to use military exports which has reflected the 1992-93 wave of Eurasianism (see Chapter One), although having had no great effect in terms of volumes of military exports by mid-1994, still has the potential to trigger international antagonism. Rotislav Beliakov, for instance, Mikoian's Design Bureau Chief, complained bitterly about the USA's attempts to curtail 'legitimate' export proposals, such as his enterprise's MiG-29 (Fulcrum, as designated by NATO); his argument was that the revenue was essential for Russia to maintain 'sufficient defence efficiency'.⁷ This readiness to reinvest military

⁶ *Aviation International News* — Farnborough '92, 7 September 1992, and *Aviaexport Information Release*, Farnborough, September 1992.

⁷ *Flight International*, 19-25 August 1992, p. 5.

export earnings into military production also belies President El'tsin's declared aim to use such revenues to support market-oriented reforms.

The Mikoian design bureau is probably the most famous of Russia's military aircraft producers, its two most advanced warplanes now being produced being the MiG-29/33 (Fulcrum) family, and the MiG-31 (Foxhound). Despite now being rather aged, having first flown in the late 1970s, the MiG-29 is still a first-class aircraft, able to compete with its top Western opponents, the US F-15, F-16 and F/A-18, albeit at a disadvantage. The traditional MiG-29A's main drawbacks include the Achilles heel of most Soviet-designed aircraft — a relatively low life expectancy of the airframe and engine, and even lower 'on-wing' life, that is the length of time between major overhauls of the engine. Other disadvantages of the Fulcrum in particular are its short range, due to low fuel capacity, and the inability of its computer/radar system to engage multiple targets, thus greatly reducing its destructive capability.⁸ To what extent the MiG-29's faults have been resolved can only be guessed, yet it seems likely that the MiG-33 was *grosso modo* the plane offered to Germany,⁹ to complement the twenty-four MiG-29's which it had inherited from East Germany and which officially came into Luftwaffe service on 1 June 1993,¹⁰ but which were rejected for active service. Although the basic price of the MiG-29/33 is less, for example, than an F-15 (about \$30m compared to \$65m¹¹), other factors reduced its value for money. The estimated running costs, in a year with 150 flying hours, were about \$1m, 20% more than the F-4; worst of all was the fleet effectiveness which was about five times worse than the F-15, in other words it was estimated that, largely because of the lower standard of computer coordination, it would take five times more Fulcrums to achieve a particular mission.¹² The provision of spares and maintenance work was the final reason why Germany decided against building on its fleet of Fulcrums, not wanting to be dependent upon Russia's

⁸ For further specifications see *Military Technology*, May 1992.

⁹ *Flight International*, 19-25 August 1992.

¹⁰ *Moscow Times*, 2 June 1993.

¹¹ *The Independent on Sunday*, 12 July 1992; and *The Guardian*, 30 July 1994.

¹² *Military Technology*, May 1992.

unstable economic and political situation for the functioning of its air force. Germany's refusal to acquire more Fulcrums, however, has not prevented other countries from wanting to join the nine non-CIS countries which already operate them. In June 1994, the Malaysian government finalized a deal with Mikoian, through the newly created state arms exporter Rosvooruzhenie, to buy eighteen MiG-29Ms for \$450m plus \$150m worth of palm oil.¹³ The Chilean Air Force is also reported to be very keen on acquiring Fulcrums to replace its fighter fleet.¹⁴ The Fulcrum was also used in a debt-for-planes swap deal with Hungary, whereby \$800m of Russia's outstanding \$1.7bn trade debt to Budapest was cancelled in exchange for 28 advanced MiG-29s;¹⁵ a similar deal has been struck with Slovakia.¹⁶

An important unknown is to what extent Western avionics may become available to complement the Fulcrum's tremendous structural and aerodynamic strengths; poorer countries such as Malaysia and Chile may not be in the market for such priced-up aircraft, but others such as India, China and Iran may well be. With state-of-the-art avionics Mikoian and Sukhoi fighters would be a force to contend with.¹⁷ Paradoxically, the fact that this would increase the need for the controversial European Fighter Aircraft and the US F-22 could create strong pressure in many quarters for facilitating the passage of modern avionics eastwards.

The MiG-31, although also a product of 1970s technology, has become a more electronically advanced and specialized fighter. China has already ordered twenty-four Foxhounds, and negotiations are supposedly in progress with other countries, including Iran.¹⁸

Mikoian is also the creator of the MiG-21(Fishbed), the world's most mass-produced jet fighter, with over 4,450 aircraft serving over thirty-five air

¹³ *The Guardian*, 8 June 1994.

¹⁴ *Flight International*, 19-25 February 1992.

¹⁵ *Business Eastern Europe*, 12 July 1993, p. 11.

¹⁶ *The Guardian*, 30 July 1994.

¹⁷ *Flight Daily News*, 8 September 1992.

¹⁸ *Flight International*, 29 July-4 August 1992.

forces, apart from the 3,000+ Fishbeds in the CIS. India's Hindustan Aeronautics manufactured the MiG-21 under licence until 1988 (and is still manufacturing the MiG-27 (Flogger)). Although exporting of new MiG-21s is out of the question, parts and servicing may still be lucrative for some time, especially as Israel Aircraft Industries (IAI) has already started negotiations with many countries wanting to update the Fishbed's avionics and/or airframe, ameliorated weapons, navigation and radar systems enhancing both air-to-air and air-to-ground attack capabilities. In some cases the updates can be to achieve interoperability with NATO systems; this may be particularly attractive to East European countries, which may potentially have great difficulty distinguishing friend from foe, and which want to quickly progress within Partnership for Peace, which has a stated aim of achieving compatibility between NATO and the East European applicants for NATO membership. UK's GEC avionics have also had talks with Mikoian about upgrading the MiG-21's weapons and cockpit systems;¹⁹ GEC have already worked on Chinese Fishbeds. Although not every possible combination will be mentioned, the option of adding Western electronics to Russian military aircraft is now a theoretical possibility for every model considered for export.

Moving now onto the Sukhoi design bureau, the aircraft commanding most interest is the Su-27 (Flanker). Few experts rate the Su-27 lower in one-on-one combat capacity than the most effective Western opponents, the F-15 and the French Rafale.²⁰ Especially with the updated electronic optic systems and radar equipment exposed at the MosAeroshow,²¹ the Flanker is the standard which other fighters have to beat. Despite the high sensitivity of such top level technology, China has signed a deal for seventy-two Su-27s, the first of which should have arrived in late 1992.²²

¹⁹ *Flight International*, 19-25 August 1992.

²⁰ *The Independent on Sunday*, 12 July 1992.

²¹ *Air & Cosmos / Aviation Magazine*, no. 130, 7-13 September 1992.

²² *Flight International*, 29 July-4 August 1992.

Of the Tupolev design bureau's military aircraft of the last few decades, only the Tu-95/142 (Bear) long-range bomber has been sold abroad, with eight units going to India. Its more feared models are the Tu-22M (Backfire) and Tu-160 (Blackjack) Mach 2+ long-range bombers, which have not been the subject of any proposed export or joint development deal rumours.

The Kamov bureau, on the other hand, has attracted a great deal of interest from the Eu and other Western countries with its Ka-50 (Hokum) attack helicopter. Despite its NATO-designated name, this is a very serious fighter aircraft, and the threat to which the projected American RAH-66 Comanche helicopter was aimed to contend with. The offering of the Ka-50 for closer Western investigation has provoked two paradoxical reactions. Some experts have been aghast at the low level of electronics aboard the Hokum (at least the versions shown at the MosAeroshow and Farnborough); expectations had been much higher, and some sources in Washington now expect the case for funding of the Comanche to be severely damaged.²³ On the other hand, Kamov's total open-mindedness to combining the Hokum with Western avionics and even weapon systems makes it an awe-inspiring competitor in the market.²⁴ Together with the fact that Kamov have declared that the Hokum will be equipped with a more powerful arsenal than any comparable helicopter, all that is missing for a truly top-class attack helicopter is the avionics to allow effective running even with a single pilot.

Such is the optimism about the Hokum in the West that several British aerospace contractors have approached Kamov in order to jointly submit proposals to fulfil the British Army's long-standing attack helicopter requirement. Although, at \$19m the price is similar to the US Army's AH-64A Apache, this would include the cost of a UK partnership to adapt the Ka-50 for the installation of British engines, equipment and weaponry.²⁵ No conclusive results of this

²³ *Rotor & Wing International Daily*, 7 September 1992.

²⁴ For technological specifications, see *Aviation Week & Space Technology*, 24 August 1992, and *Aviation International News*, 7 September 1992.

²⁵ *Show News*, Farnborough, 9 September 1992.

tender proposal have emerged, although rumours have circulated to the effect that the Kamov offer's chances of success were practically nil. Other customers are now actively being sought, however, by Kamov's new American partner — Group Vector.²⁶ One main advantage is that the Ka-50 has received export clearance from the Russian government, and should be offered to foreign customers from 1993.²⁷

The other important Russian military aircraft producer of the last years, Iakovlev, has concentrated on V/STOL (vertical / short take off and landing) aircraft in the military field, first the Iak-38 (Forger), and then the Iak-141 (Freestyle). The Forger was never exported, and its attrition rate was relatively high, with at least thirty-six aircraft being lost (according to Iakovlev). Although sharing some similarities, the Forger's successor, the Freestyle, is very different,²⁸ and has undeniably broken barriers in VTOL technology.²⁹ Despite its potential, government funding for the project dried up in 1991, and Iakovlev have tried to offer other countries (including China and India) a share in it, but so far to no avail.³⁰ As explained below, however, the privatization of the Iakovlev complex is likely to mean the end of the Freestyle. It also seems that the Iak-UTK advanced jet trainer, which was rumoured to have won contracts from the Russian Air Force and Navy, has been abandoned. This project was already at an advanced stage, and foreign cooperation was at a more elaborated stage than most military projects. Rockwell-Collins were to supply the cockpit avionics. The St Petersburg Klimov bureau had formed a new company, MTA (Motor Turbine Aggregate) with the French aero-engine company Snecma, to develop the jet trainer engine, using the existing Larzac West European core, and a Klimov-designed fan.³¹ The fruits of this cooperation are now almost certain to be used on the MiG-AT (Advanced Trainer).

²⁶ For details, see *Flight International*, 29 July–4 August 1992.

²⁷ *Show News*, Farnborough, 9 September 1992.

²⁸ See *Flight Daily News*, 8 September 1992.

²⁹ *Show News*, Farnborough, 9 September 1992.

³⁰ *Jane's Defence Weekly*, 5 September 1992.

³¹ *Interavia Aerospace Review*, July 1992.

Much could also be written on missile and radar technology, and their export potential, but that is more closely related to armaments, and is beyond the scope of this section.

A1.3 Conversion and Restructuring of Russian Aeronautics Enterprises

The conversion of the military-industrial sector has attracted much attention; it is often assumed that considering Russia's tremendous military might, the transfer of this productive capability to consumer commodity production would solve the worst economic problems, not least by interesting Western customers. In reality, there are no simple solutions. The intention has been to halve defence spending in the FSU, from an estimated minimum of 20% of GNP to below 10%. If we compare this to the situation in the USA, where the attempts to bring this figure down from 5.3% in 1990 to 3.9% in 1996³² have been causing significant profit losses and unemployment, it becomes clear that the scale of the problem in Russia is overwhelming, especially considering that few non-military industries are in a state to offer large-scale alternative employment.

Many specialists now doubt that the military sector was more efficient than the civilian sector, rather than simply more effective, believing that the defence industry's successes were attributable merely to the fact that it could work with a 'success at all costs' approach, having priority access to resources (including imports), and few limits to production costs. Russia has the additional disadvantage that many of the most advanced spheres of the Soviet defence industry were based in other republics, notably in electronics, whilst ground equipment and conventional armaments were based around specific central areas, for example in the Urals, or shipyards in Leningrad.³³ S. Elekoev of IMEMO argued that even if military technology was very efficient, there is no reason to

³² Thierry Malleret, *Conversion of the Defense Industry in the Former Soviet Union*, New York, 1992, p. 9.

³³ Thierry Malleret, *op. cit.*, p. 51.

believe that the civilian economy would do a better job at incorporating it than with imported Western equipment which has been poorly used, for example at the VAZ and KamAZ plants.³⁴

Although conversion is aimed to be a budget-saving operation, its own costs are enormous, and the massive capital needed for successful conversion is lacking. As the pressure to reduce the budget deficit increases, chances of increasing assistance to conversion are reduced. In the 1990 draft state programme for conversion, the military industry committee of the Council of Ministers of the USSR, and associated ministries, allocated Rb60bn to conversion — clearly too little, and too late, as many enterprises had already ceased production due to lack of funds.³⁵

As far as the aeronautics industry is concerned, conversion could be relatively successful as much of it may use 'conversion by speciality'. Although this has sometimes meant simply using revenue from selling military goods to support reforms in the economy, the term normally refers to adapting existing military production so that it can be used for civilian uses. Not that the aviation industry has escaped central orders to increase low technology civilian production — the Aviastar complex was told to produce refrigerators.³⁶ whilst Sukhoi was pushed into starting to manufacture salt and tea packaging machines.³⁷ Producing consumer goods was not new to the aeronautics industry, however, as it had long produced agricultural equipment, industrial equipment, electronic and communications equipment. Yet this was to increase further with conversion. The plan was for the enterprises under Minaviaprom (the Ministry of Aviation Industries) to increase their production of food processing equipment first to 43% of the Soviet total, and eventually to 65%.³⁸ Although in some cases this production has created essential revenue at a time when aircraft orders were low, few manufacturers were pleased with this forced diversion of resources and

³⁴ Thierry Malleret, *op. cit.*, p. 24.

³⁵ *Moscow News*, no. 39, 1990.

³⁶ *Flight International*, 29 July-4 August 1992.

³⁷ *Moscow News*, no. 39, 1990.

³⁸ Thierry Malleret, *op. cit.*, pp. 63-71.

wastage of expertise. Nonetheless, switching to civilian aircraft was still the declared priority of conversion in the aeronautics sphere, although one important restriction is that by no means all of the military production capacity can be used on civilian output. It has been estimated, for example, that due to the high level of specialization in Soviet military work, around 90% of the research realized in the aeronautics field cannot be adapted to civilian production.³⁹

The 1991-92 period saw the beginning of the decline of conversion as a priority, whilst privatization became the figurehead of economic reforms. Staying in the military sector was simply not an option for most enterprises, for reasons made clear in the following table:⁴⁰

UNITS PRODUCED			
Weapon category	1990 (USSR)	1991 (USSR)	1992 (Rus.)
Bombers	35	30	20
Fighters/Fighter Bombers	575	350	150
Attack Helicopters	70	15	5

Figures for export earnings of arms tell a similar story; earnings from the FSU fell from \$6bn in 1991 to \$2.5bn in 1992, Russia's share accounting for 90%.⁴¹ It became increasingly clear that the Russian government could be of only very limited help in the shift away from military production. The total budget for conversion projects in 1993 was Rb50bn, or around 1% of GDP at mid-1993 prices, but even that frugal allowance was reported to be suffering from a 60% shortfall in distribution, particularly damaging to the converting enterprises due to the virtual hyperinflation. Keith Bush wrote that

After years of little evident progress in the conversion/diversification of the Russian defence industry, a turning point was reached in 1993. [...] the political leadership, and most defence industry executives, realized that the funding for conversion would have to be generated by the enterprises themselves after

³⁹ N. Nikitin, 'Polozhenie obiazivaet', *Krasnaia Zvezda*, 13 April 1990.

⁴⁰ *Aviation Week & Space Technology*, 28 June 1993.

⁴¹ *Ibid.*

privatization, and not from central budgetary sources in the shape of outright grants or soft credits. [...] a decision appears to have been made at cabinet level in mid-1993 to expedite the privatization of the defense industry and to expand the categories of enterprises that could be sold off.⁴²

This meant that many aeronautics companies started leaving the state sector, and therefore the obligation to follow state conversion plan objectives. With costs growing exponentially, and both orders and state financial support dwindling, becoming independent, both for the capital from shares and from potential new partners, was often the only alternative. Such examples of 'entrepreneurial conversion' as Iakovlev, Sukhoi, Tupolev and Aerostar are all covered below.

Every military aircraft producer, in sharp contrast with the guaranteed state orders of the Soviet days, is now striving to find a product with which to successfully break into the world market. Trying to succeed with an amphibious aircraft is the BETA IR joint enterprise, comprised of the Beriev Research and Development Complex, the Taganrog Aviation Production Association, the Irkutsk Aviation Production Association (which also manufactures Su-27s), and the Swiss investment firm ILTA Trade Finance S.A.. This project should result in the production of the 64-passenger Be-200, an amphibious plane adaptable to cargo, fire-fighting or naval surveillance roles. There is supposedly much interest in the West in the Be-200, and Beriev estimate a demand for 500 such planes abroad, and 350 in Russia.⁴³ This is a rare example of a part-foreign joint enterprise obtaining money from the government's conversion fund; it had already committed Rb150m (before the autumn of 1992), and has declared its intention of contributing a total (but how will it be indexed?) of Rb2bn by the year 1996.⁴⁴

⁴² 'Aspects of Military Conversion in Russia', *RFE/RL Research Report*, vol. 3, no. 14, 8 April 1994, pp. 31-33.

⁴³ *Commerzant*, 15 September 1992.

⁴⁴ *Commerzant*, 15 September 1992.

The Mikoian company has been working on commercial projects since 1989, and has attracted particular attention for a project for the joint development of airframe components for commercial aircraft with the French firm Dussault.⁴⁵

The Sukhoi complex broke away from its top-secret production tradition in 1990, with its readiness to export the Su-26 acrobatic plane. The Su-26 was, according to Sukhoi, the result of an intensive study of Western markets, and an opening in the market was judged to exist in the market for high-performance light aircraft, as these were overly engineering-intensive to be profitably produced in the West.⁴⁶ Sukhoi went on to produce the Su-29, which has been chosen as the first aircraft to be examined under the US/Russian bilateral aviation agreement for joint certification, which if passed would make CAA (Civil Aviation Authority) certification to fly in Britain 'for hire or reward' very likely.⁴⁷ The market for such planes in Russia at the moment is virtually non-existent, as individuals do not yet have the right to own aircraft.

The end of state control over most of the aeronautics industry was assured by its inclusion in the privatization process. As in most other industries, however, aircraft producers had to reform more than the ownership structure to become viable entities in a competitive world. Whilst previously different roles in the aviation industry had been clearly delineated, it now became essential for enterprises in the various fields of aeronautics production to join forces.⁴⁸ Without the safety of state orders, every enterprise had good reason to seek partnerships which could ensure preferential and reliable supplies or orders.

The oft-mentioned Ulianovsk Aviastar Complex is a good example of privatization with which to start. Claimed to be the largest aviation enterprise in the world, its future hung in the balance in late 1991, military orders having fallen to negligible levels, and government funding for the completion of an engine plant

⁴⁵ *Aviaexport Newsletter*, Farnborough, September 1992.

⁴⁶ *Moscow News*, no. 39, 1990.

⁴⁷ *Farnborough 92 International*, magazine of the Society of British Aerospace Companies, September 1992.

⁴⁸ *Kommersant*, no. 11, 15-21 March 1993.

having then apparently run out. Rather than let the complex shut down, Executive Director Vladimir Mikhailov prepared to make this \$8bn enterprise (Aviastar's own estimate) independent. Almost overnight, Ulianovsk went from being entirely financed by the state to becoming totally self-financing. Ulianovsk brought together a multinational management team including experts from Avtovazbank, Price Waterhouse and Morgan Grenfell. The Aviastar group clearly had much to offer; it was producing two of the Russian aircraft with the greatest export potential, the An-124 and the Tu-204: it also had a head start in a process which many other aeronautics corporations were going to have to begin from scratch, namely the bringing together of all levels of aircraft production, from design to interior finishing. Not only did this mean that subsidiaries like avionics developers or design bureaux finally benefited directly from their production, but it also avoided the duplication of machine-tools in both design sections and mass production factories.⁴⁹

Western support was going to be useful in areas other than pure financing. Volga-Dnepr Airlines was partnered with British firm Heavy-Lift, thus helping to find hard-currency custom. Airliner interiors are one of the most constantly criticized aspects of Russian aircraft, and yet the cheapest way to make them user-friendly. Finally aware of this problem, Aviastar established a joint venture with Hunting Aircraft and Aviation Ventures (both from Britain) to form AVINTCO, which would manufacture world-class aircraft interiors at Aviastar.⁵⁰ Another criticism with which Western partners could help is one not directed at airliners themselves, but at the industry — the inability to reproduce the highest technology in sufficiently large quantities, in other words to move from quasi-cottage industry production of high technology, to mass production.⁵¹ It has been suggested that much of the enthusiasm about exporting Russian planes may be overly optimistic, when there are not enough new planes being produced for the domestic market; for example, Iliushin has been very late in its delivery of Il-96s

⁴⁹ *Flight International*, 29 July–4 August 1992.

⁵⁰ *BEE*, 14 June 1993, p. 9.

⁵¹ Thierry Malleret, *op. cit.*, p. 12.

to Aeroflot.⁵² In Ulianovsk's case, although Western experts have reportedly estimated that such an installation could produce 250 aircraft annually, in 1992 Aviastar was only assembling four An-124s, and around 11 Tu-204s.⁵³ Although Aviastar registered as a holding company in 1993,⁵⁴ a high level of interdependence with the government remains. Thus in July 1993, the Russian government declared that it will offer preferential treatment to Aviastar, in order to retain some control over the plant.⁵⁵

During the same period the Iakovlev aviation corporation was also about to register as a joint stock enterprise. In a similar situation to Aviastar, in 1992 Iakovlev's military orders were down to nothing, its funding from the government was a ridiculous Rb34m, and if it was not for an order to produce the 170-passenger Iak-46, it would have been bankrupt at one point; privatization was its only chance. Iakovlev's plan to become an open joint stock company was approved by the Russian government in December 1992, and supported by the Moscow Committee for the Management of Property.⁵⁶

For privatization to be approved, Iakovlev had to satisfy the Russian Committee on Defense Industries (Roskomoboronprom) that it would totally stop work on fighters and strategic bombers; as mentioned in the section on conversion, this leaves unclear the position of its UTK fighter trainer aircraft. Iakovlev's restructuring also had a merging dimension, with the amalgamation of its Skorost' experimentation and construction plant with two serial production plants. Iakovlev's Director Oleg Demchenko does not intend, however, to fuse an engine-producing plant to their complex; he aims to have a Western approach, whereby Iakovlev can offer their clients a choice of engine. In this he differs

⁵² *The Financial Times*, 2 September 1992.

⁵³ *Flight International*, 29 July-4 August 1992.

⁵⁴ Presentation by Vladimir Mikhailov, Chairman and Executive Director of the Aviastar Aviation Complex, at the 'Development of a Modern Air Transport Industry in the CIS' Conference, 14 May 1993.

⁵⁵ For details, see *Aviation Week & Space Technology*, 12 July 1993.

⁵⁶ *Kommersant*, no. 11, 15-21 March 1993

from Tupolev's General Director Valentin Klimov, who believes every single stage of production should be united.⁵⁷

The Kamov bureau went through the privatization process in the first half of 1993, the firm itself initiating the move, and eventually obtaining Ministry of Defence approval.⁵⁸ The Sukhoi Construction Bureau, although having kept 95% of its production in the military sector, also had its privatization approved.⁵⁹ Like Tupolev and Antonov, the Sukhoi complex is uniting its design bureaux with its production plants, and like Tupolev, precise privatization proposal details were undisclosed.⁶⁰

A1.4 Purely Russian Civil Aviation Export and Leasing Projects

With state orders for aircraft at a fraction of what they used to be, and as the internal commercial aircraft market remains weak, the pressure is great on aeronautics enterprises to find customers abroad. The procedures needed to sell or lease commercial aircraft are much more complicated than the situation with military aircraft, where governments played a much greater role in funding, insuring and permitting flights.

Before a potential client can be interested in acquiring an aircraft, he/she must know that that aircraft will receive the right to fly and land in all necessary countries. If an aircraft is only to be used as an exception, in a one-off leasing arrangement, special permission can usually be arranged, after some time and expense. For an aircraft to be a viable purchase, however, it needs to be fully certified by the purchaser's national aviation authority. In the case of leasing, military and commercial aircraft are treated differently; for example, at Farnborough 1992 a military An-124 had to be used rather than the planned

⁵⁷ *Kommersant*'', no. 11, 15-21 March 1993.

⁵⁸ *Rabochaia Tribuna*, 28 May 1993.

⁵⁹ *BEE*, 22 February 1993, p. 11.

⁶⁰ *Kommersant*'', no. 11, 15-21 March 1993.

civilian one, as permission could be granted using its well-known military certification, but not the unrecognized Russian civil certification.⁶¹ Reaching certification which is internationally recognized and respected is becoming easier than the previously bilateral-based system through the Joint Aviation Requirements (JARs) being increasingly used in Western Europe. At present the JARs are voluntarily adhered to, but they should gradually have become compulsory by 1996. Russia has not yet joined the Joint Aviation Authority, but membership is being discussed; a more Western approach to certification could solve many problems. Factories designing new aviation parts in the West, for example, tend to have their own in-house aviation authority representative, helping, advising and verifying throughout the design and production processes, thereby minimizing the time required to achieve certification. A senior JAR representative suggested that sending such representatives to Russian firms might be subsidised.⁶² Tupolev and Rolls-Royce probably wished they had done the same at an earlier stage, as the international version of the Tu-204 was experiencing certification delays in mid-1993.⁶³

Lack of information, which has already been marked as a deterrent to efficient production, is also hindering certification and affordable insurance, and therefore sales. Russia could probably prove the high worth of many of its aircraft, but international values and evaluators must be used. Comprehensive data for every aircraft type is needed so that Western insurance brokers can minimize perceived probability of error, and therefore offer less expensive policies. Until there is sufficient capital in the newborn Russian insurance sector, there will be a continued need for Western brokers on important covers.⁶⁴ Gradually, nonetheless, some Russian insurance companies are gaining trust, by honouring claims, and by correctly estimating risks; so far, however, access to the

⁶¹ *Aviation International News*, Farnborough '92, 7 September 1992.

⁶² Interview with Captain T. H. Sindall, Principal Inspector for the Civil Aviation Authority's Safety Regulation Group, 13 May 1993

⁶³ Interview with Richard D. Ciochetti, Rolls-Royce's Chief Representative in Moscow, 1 June 1993.

⁶⁴ Interview with John Howard, Director of the Aviation Division, Gibbs Hartley Cooper Ltd., 13 May 1993.

necessary Russian data to do this has been restricted, again necessitating privileged links to be effective.⁶⁵ Not only freely available information is needed, but a new approach to enforcing standards; there is much talk now about making accident data available, but establishing normalized and well-followed operational guidelines is also essential, in areas such as improved fuel needs calculation, as well as packaging and marking of dangerous goods.⁶⁶ These measures would mean not only lower insurance rates, but also greater customer assurance, and therefore more demand for the aircraft.

All the same factors which apply favourably to insurance clearly also assist in the organization of financial arrangements for the purchase or lease of Russian aircraft. Especially with the need to compensate for political risk, as well as unpredictability and poor enforcement of property and commercial law, information gathering and dissemination in order to facilitate risk assessment must become a priority.

Although the vast majority of promising aircraft being offered for export include some Western equipment, there are some notable exceptions. The giant An-124 is not only being offered on lease, as examined later, but should also soon be available for export. Although Russian customers are lining up for it, Volga-Dnepr has priority as it is part of the Aviastar Complex producing them (although they are also being produced in Ukraine, at the Antonov plant in Zaporozhe), and Volga-Dnepr intends to be involved not only with leasing, but also with sales of the Ruslan. Lufthansa has already expressed great interest.⁶⁷

Other examples of non-Western equipped aircraft being exported include the old Iak-18;⁶⁸ Tupolev's Tu-204s with Solovev PS-90A engines from

⁶⁵ Interview with Nikolai P. Ustimenko, Director General of the 'AVICOS' aviation insurance joint-stock company, 13 May 1993.

⁶⁶ Interview with Captain T. H. Sindall, Principal Inspector for the Civil Aviation Authority's Safety Regulation Group, 13 May 1993.

⁶⁷ *Flight International*, 29 July-4 August 1992.

⁶⁸ *Kommersant*, 23 March 1993.

Kirgizstan's national airline;⁶⁹ Kamov's popular Ka-32 helicopters;⁷⁰ and, finally cleared for certification, the Iliushin Il-114.⁷¹

All-in-all, though, existing Russian planes in the present world market seem now to be more appropriate for the lower end of the wet-leasing market than for sales. Offering extremely competitive rates, Russia is in fact a major player in the international leasing market.⁷² The star of the Russian leasing fleet is the An-124 'Ruslan', the largest non-prototype plane in the world, flown by, *inter alia*, Volga-Dnepr Airlines. Volga-Dnepris now expanding its fleet of Ruslans; the next one is going to be leased to them, and is to be paid for by loans from the Stolichnyi Bank.⁷³ As has tended to be the case for most successful CIS airlines, help from the authorities has been a necessary key to Volga-Dnepr's success.⁷⁴ As mentioned earlier, the government also offered a long-term loan to Volga-Dnepr Cargo Airlines, to enable it to buy its six Ruslans.⁷⁵ One of Volga-Dnepr's business deals is an agreement with Airbus Industrie, to fly sections of Airbus between the plants in Manchester, Bremen and Toulouse, once appropriate certification has been received.⁷⁶ Other Ruslans are hired by petroleum companies, such as Canadian Fracmaster, to transport their equipment to Siberia.

Aeroflot itself has resorted to leasing to increase its revenue, mainly Tu-154s and Il-76s going to lesser developed countries. The possibility of leasing out aircraft together with Russian crew is also being discussed, particularly with Iran and Nepal.⁷⁷ Aeroflot has much competition from other Russian enterprises, however.

One such new airline is the Polar Air Company, which emerged from the old state-owned Polar Air, and is now keen on using Western marketing

⁶⁹ See *Air & Cosmos/Aviation Magazine*, no. 1393, 28 September-4 October 1992.

⁷⁰ *Rabochaia Tribuna*, 28 May 1993.

⁷¹ See *Aviaexport Newsletter*, Farnborough '92 special edition, September 1992, and *Aviation Week & Space Technology*, 12 July 1993.

⁷² Interview with Paul Hayes, Director of Product Development, Airclaims Ltd., 11 May 1993.

⁷³ Presentation by Alexander Bashkov, Financial Director of Volga-Dnepr Airline, at the 'Development of a Modern Air Transport Industry in the CIS' Conference, 12 May 1993.

⁷⁴ For details, see *Stolitsa*, no. 5, 1992, p. 12.

⁷⁵ *Aviation Week & Space Technology*, 12 July 1993.

⁷⁶ *Flight International*, 29 July-4 August 1992.

⁷⁷ *Aviation Week & Space Technology*, 21 September 1992.

techniques, and a new office on London's Regent Street, to obtain foreign contracts. The company plans to start with the acquisition of three Il-76 TD jet freighters, available for any kind of lease, or for sale.⁷⁸ Many air leasing specialists are optimistic about the role of the Il-76, although one great disadvantage is particularly high fuel consumption.⁷⁹

Another new airline intending to acquire an Il-76 is the Aviaross Aviation Company. Aviaross has been looking for a partner to supply the capital to buy an Il-76, hoping to use a lower purchase price as motivation, or a joint leasing deal using Aviaross' experience and contacts. As it is, Aviaross have two An-32 turboprop cargo planes, and deals clinched so far with these have included charters for Sub-Saharan governments. Aviaross also point out that starting off was difficult, and that contacts were invaluable; the President of the company previously held a senior post in the Ministry of Transport. Aviaross also has both IATA and ICAO recognition; IATA certification was, unusually, acquired through Aeroflot. Credit to buy the An-32s was not the least of the problems; it could only be obtained for three-month periods, at 100% interest for that period. Nonetheless, Aviaross managed to repay its debts within a year.⁸⁰

Russian helicopters are also in great demand on the leasing market, and Eveready PANH Aviation Services, a section of Krasnodar's NPO PANH GA (Scientific-Production Complex of Civil Aviation Usage in the National Economy), is one of the recently formed private companies to provide such a service. PANH Aviation is a member of the Helicopter Association International, and the American Helicopter Society, and it claims that its prices are higher than many other Russian firms because of their higher degree of professionalism and reliability of their insurance. Nonetheless, a problem common to most such companies was immediately apparent from the very poor quality of graphics and English language on the publicity leaflet, and by the fact that the prices were only

⁷⁸ *Show News*, Farnborough, 8 September 1992.

⁷⁹ Interview with Craig Mariacci, Sales Manager, Skyplan Services International (Calgary), 11 May 1993.

⁸⁰ Interview with Sergei Leonidovich Vekhov, Manager of Aviaross Aviation Company, 13 May 1993.

'very approximate'. Obtaining necessary authorizations to fly abroad is said not to have been particularly problematic; even in the case of flying the uncertified Ka-32 to Ireland, it merely took a few weeks to obtain the necessary special permission. In such cases, however, small companies are at the mercy of the efficiency, or otherwise, of the commercial section of the relevant Russian embassy, if unable to pay for private assistance. Helicopters have an advantage in that they are not required to obtain landing rights. The main problem, it was stated, was finding enough foreign customers. As with other small leasing companies, such as Aviaross, PANH aviation do not normally bother flying within Russia, unless being paid handsomely in hard currency; unreliability of fuel source, of catering, and bribes having to be paid, all made domestic leasing more trouble than its worth, at the time of the interview.⁸¹

These examples of new airlines are but a small sample; there are now over a hundred new airlines in the CIS. That does not mean that the above enterprises are typical; they are part of a minority who have broken out into the international market. They have all been helped either by having been important state organizations before privatization, and/or by having managerial cadres who have highly-placed contacts in the air transport authorities. Nonetheless, they are the important precedents, showing that it is possible for entrepreneurs to make a profit by selling the use of Russian aeronautics technology abroad.

The problems involved with international flight permission, flight plans, landing permissions and other organizational support for Russian aircraft is an area where many Western enterprises are achieving business;⁸² marketing is becoming another important role, as many new airlines complain that to get contracts, for example with the UN, contacts are essential. Calgary's Skyplan has been playing this role, for example with the An-124s and Il-76s, Rostov helicopter enterprises have employed British Carroll Aircraft Corporation to

⁸¹ Interview with Sergei Alekseevich Korobko, representative of EVEREADY PANH AVIATION SERVICES (Krasnodar). 12 May 1993.

⁸² Interview with Craig Mariacci. Sales Manager, Skyplan Services International (Calgary). 11 May 1993.

certify and to market the Mil Mi-26 helicopter, and Iliushin have UK-based Euro Iliushin Aircraft Sales. Yet confusion still appears prevalent amongst Russian aviation companies, especially small leasing companies, as how to best break into the international market, suggesting that such Western support organizations can be faulted on not publicising their services widely enough.⁸³

It is essential that Russian export and leasing projects do break into this market in the near future, as the opening up of the FSU has created vast opportunities for the likes of Boeing and Airbus, whose aircraft Russia will not only have to match in performance and/or prices, but beat in order to compensate for the difference in experience and reputation. This is made even more difficult with the cost of leasing Western aeroplanes, particularly the older models, now at enticingly low levels.

Despite initial registration and insurance problems,⁸⁴ Aeroflot has already purchased five Airbus A310-308s⁸⁵ and signed a letter of intent for the leasing of four Boeing 767s.⁸⁶ The first new passenger airline to offer scheduled flights, Transaero, is also the first airline to fly Western planes on domestic routes, having acquired two B-737s, as well as placing an order in the spring of 1994 for two B-757s.⁸⁷ Western business jet operators are finding a growing leasing market in former Eastern Bloc countries.⁸⁸ Even Volga-Dnepr airlines, although having achieved profitability with the use of Russian aircraft, announced in June 1994 that it would also start leasing Western cargo planes. Both Boeing and Airbus have expressed interest.⁸⁹

A1.5 Partnerships Amalgamating Russian and Western Hardware

⁸³ *Aviation Week & Space Technology*, 21 September 1992.

⁸⁴ Presentation by Dominique Menu, Manager of the Banque Nationale de Paris in Moscow, at the 'Development of a Modern Air Transport Industry in the CIS' Conference, 14 May 1993; and interview with M. Kramer, Airbus senior executive, 5 August 1992.

⁸⁵ *The Financial Times*, 12 June 1992.

⁸⁶ *BEE*, 31 January 1994, p. 8.

⁸⁷ *BEE*, 18 April 1994, p. 8.

⁸⁸ *Aerospace World*, September 1992.

⁸⁹ *BEE*, 6 June 1994, p. 12.

Most of the other aircraft packages being offered on foreign markets at present have an element of international partnership to them. One of the main reasons for opening up the industry to foreign companies, a process initiated by the USSR Ministry for the Aviation Industry in 1990, was the fear that in the near future existing Aeroflot planes would no longer be allowed in Western airports, due to their levels of noise and air pollution.⁹⁰ Increasingly, however, it is not only Western customers who will demand Western components; as prices of Russian aircraft are driven ever closer to Western levels, even traditionally less demanding customers will now require the same benefits as offered by Western aircraft, and Western partners are consulted mostly in regard to avionics, cockpits, and engines. The main advantages are fuel efficiency, maintenance cost savings, pilot/ATC⁹¹ friendliness, and customer trust and recognition. For all these reasons, there has been an unprecedented movement towards establishing partnerships or finding foreign contractors to assist export sales, and gradually domestic sales also.

This tendency is not without its problems or its opponents. Mark Vineberg, General Director of the Mil Design Bureau, expressed caution at the prospect of being too dependent upon Western partners, and supported Rutskoi's (then Vice-President) suggestion of a return to a greater degree of Governmental support, even though his own enterprise has not been without success at finding foreign collaborators.⁹² Tupolev's General Director also expressed a desire to see a limit on foreigners' involvement in the industry, hoping the domestic market would remain Russian;⁹³ his reluctance to see Tupolev's 60% of that market being challenged is hardly surprising, however. Yet this concern is by no means purely an issue of self-interest; it is very clear that partnerships with foreign enterprises will almost exclusively deal with the few aircraft which are

⁹⁰ *Kommersant*'', 14 June 1993.

⁹¹ ATC = Air Traffic Control

⁹² *Moscow Tribune*, 26 May 1993.

⁹³ *Kommersant*'', no. 11, 15-21 March 1993.

internationally competitive. If no supplementary support is offered by the Russian government or IFIs, all other types of aircraft will instead gradually be replaced by foreign models. Although this is often an inevitable process as all economies become more internationalized, in this case it can be argued to be particularly regrettable, as much of the existing expertise and infrastructure of the aeronautics industry in Russia may be lost without having been given a reasonable adaptation period to carve out a place in both the domestic and international markets. In some cases it may already be too late; whilst the trend now is to obtain Western avionics, there are claims that in some aspects the Russian systems were superior, but priorities of compatibility and reputation have prevailed. There is regret that joint development of systems did not start early enough.⁹⁴

From the point of view of Western enterprises investing in the Russian aeronautics industry, the situation is also very difficult. Worst of all are the political, legal and monetary instabilities mentioned in chapter three. The different approach to work, to respecting schedules and customer expectations all regularly emerge as grievances, as well as the huge cost of introducing Western levels of quality control. Added to this, in the aeronautics industry, are the certification, finance and insurance problems. Another restrictive factor is the lack of funds behind local demand; domestic sales cannot be counted on for a very long time as a source of profit, as higher prices cause a decrease in Russian air travel.

Despite all the problems and worries, important partnerships are being struck. Not least because of Russia's large, well-disciplined and aviation-oriented workforce, and the presence of enormous production facilities, the degree of interest and support from Western partners has been extremely high. First we will examine the two most important projects to join Western technology to Russian airframes thus far, involving the Tupolev 204 and the Iliushin 96.

⁹⁴ Interview with Tupolev engineers. 7 September 1992.

The task of fitting the Tu-204 with Rolls-Royce engines is one which both companies started working on in early 1990. One of the highlights of this project is the company which was formed to run it — BRAVIA (standing for the British Russian Aviation Company), is a Russian Joint Stock Company which was formed in April 1992, its shareholders being London-based Flemings Merchant Bank (or more precisely their Flemings Russia Investment Corporation venture capital fund; they control 50% of BRAVIA's shares), the Tupolev Design Bureau, and the Ulianovsk Aviastar Complex. Such a sizable project involves many risks, and so Anatolii Bratukhin, head of the Russian Aviation Industry Department, was found in order to provide high-level governmental support.⁹⁵ Rolls-Royce could not be a shareholder, because of conflicts of interest with their involvement with the B-757,⁹⁶ but it does have a member on BRAVIA's Council. For the Rolls-Royce powered version of the Tu-204, BRAVIA is responsible for the engines, the avionics, interior, certification, sales and customer support. It has exclusive sales rights.⁹⁷ The Russian partners are to cover the costs of technical work on airframe modification and of certification programmes (a similar arrangement exists with the Iliushin-96 project).⁹⁸ Regardless of the widespread claims of differences in approaches and of infighting, the BRAVIA team have managed to get the first major re-engined Russian aircraft airborne almost on schedule. It must also be stressed at this stage that despite the attention this project has received, Western investment has not been massive; the fact that the engines remain the property of the Western partner means that only the relatively low costs of staff, travel and Russian offices have to be disbursed.

Such re-engining is not possible with any combination of plane and engine, even if the thrust level would appear to fit. A tremendous amount of adjusting has to be done and great attention must be focused on not compromising the

⁹⁵ BRAVIA Farnborough '92 Briefing, September 1992, and *Interavia Air Letter*, 13 April 1992.

⁹⁶ Interview with N. P. Whittaker, RR Sales Financing Manager, 12 July 1992.

⁹⁷ Presentation by George Horton, Head of BRAVIA and of the Flemings Russian Investment Corporation (FRIC), at the 'Development of a Modern Air Transport Industry in the CIS' Conference, 13 May 1993.

⁹⁸ *Interavia Aerospace Review*, July 1992.

design and safety criteria of the airframe. Although the RB-211/Tu-204 combination was possible, it involved a great deal of re-adaptation work. The reasoning behind re-engining must be very good to justify the RB-211's cost of \$6.5-8m, when compared with the PS-90A's price of around \$320,000. According to BRAVIA's Mike Blore, the main advantage of the Western engine will be in reliability and operational costs.⁹⁹ Furthermore, the RB-211 is a definite winner with noise levels; it passes European and American Stage 3/Chapter 3 criteria, which is essential if the aircraft is ever to break into Western markets in the longer-term.¹⁰⁰

The international version of the Tu-204 does not only have Rolls-Royce as a Western supplier. Hunting Aviation will supply the interiors, whilst a cargo system package will be provided by the Pemco Aircraft Cargo Systems Division, of California.¹⁰¹ Collins are responsible for the avionics.

There were delays holding up Russian certification of the RB-211 powered Tu-204, although it was expected that full JAR flight certification would be achieved in the first quarter of 1994, and full JAA certification in 1995-96. With the aircraft having reached marketing stage, BRAVIA have set up a leasing group, as outright buying has now become a rarity. The targeted market consists of Russian airlines, especially for their international routes; other CIS airlines, and CIS routes; and airlines from developing countries.¹⁰² Although conflicting evidence has emerged about the cost, it is usually estimated at \$35-40m. To hedge their investment, BRAVIA have diversified, starting with a series of wood-processing ventures, already established in Ulianovsk, Izhevsk and Krasnodar.¹⁰³

Now that this particular project is past its worst problems, it is possible that other variants, and in particular a Pratt & Whitney powered version of the Tu-204, to be called the Il-96M, could become a reality. This project has been

⁹⁹ *Flight International*, 12-18 August 1992.

¹⁰⁰ *Aviation International News*, 7 September 1992.

¹⁰¹ *Aviation Week & Space Technology*, 12 July 1993; and presentation by George Horton, Head of BRAVIA and of the Flemings Russian Investment Corporation (FRIC), at the 'Development of a Modern Air Transport Industry in the CIS' Conference, 13 May 1993.

¹⁰² *Ibid.*

¹⁰³ *Kommersant*, 14 June 1993.

talked about for almost as long as the Rolls-Royce partnership, but the level of commitment needed to make the first project succeed has so far kept Pratt & Whitney by the wayside; exactly the same reasons are blamed for Rolls-Royce not yet having a firm foothold in the Il-96 re-engining programme.

The Iliushin-Pratt & Whitney venture is not a partnership in the same sense as BRAVIA is; Pratt & Whitney remains a contractor of Iliushin, and the other seventeen Western suppliers are also contracted by Iliushin, thus absolving P&W of unnecessary financial responsibility. Yet even in this case, a memorandum of understanding was signed by Iliushin, P&W and the Russian government's Anatolii Bratukhin.¹⁰⁴ In this project also, the engines on the prototypes remain the property of the Western manufacturer, and major capital investment from the Western side is avoided; estimates of P&W's investment are approximately \$60-\$100m. Financing from the Russian side is said to have been a problem, and barter possibilities are still being looked at as a way to allow further investments.¹⁰⁵

The reasons for choosing the PW-2337 instead of the PS-90As are the same as in the Tu-204 project. The adaptation work required, however, is substantially different for both Russian and Western partners.¹⁰⁶

Of the other Western components provided for this project, the cockpit and avionics are being supplied by Rockwell-Collins, who have subcontracted Smiths Industries for the flight management system, and Litton for the inertial reference system.¹⁰⁷

There is even more optimism about the Il-96M than there is about the Tu-204, some experts expecting it to take away much of the A-340's custom:¹⁰⁸ the June 1993 Paris Airshow saw an order by the Dutch company Partnair for five Il-

¹⁰⁴ *Interavia Air Letter*. 13 April 1992.

¹⁰⁵ Interview with George Dieck, Project Engineer, PW 2000 Russian Program, 19 March 1993.

¹⁰⁶ See *Interavia Aerospace Review*, July 1992, and *Aviation International News*, 7 September 1992.

¹⁰⁷ *Ibid.*

¹⁰⁸ Interview with Craig Mariacci, Sales Manager, Skyplan Services International (Calgary), 11 May 1993.

96Ms. and five Il-96Ts.¹⁰⁹ The latter is the cargo version, also powered by PW2337s, and viewed as the ideal vehicle to break into the Western market, avoiding the effect of any possible passenger prejudice against Russian planes.¹¹⁰ It is apparently this hard currency order which secured intervention by Prime Minister Chernomyrdin, granting major tax and tariff concessions to P&W-powered Iliushins.¹¹¹ Production deliveries are expected to begin in 1995,¹¹² and the conglomerate is hoping to produce around 300 of these aircraft over the next ten to fifteen years.

Iliushin are also involved in a much smaller project, to re-engine the Il-103. UK-based Euro Iliushin Aircraft Sales is initially importing twenty of these four to five seater airframes, most likely to be coupled with Continental engines of about 200 horse power. The company expects to provide \$3.5m to assist the manufacturing process in Russia.¹¹³ The Il-114, described in the previous section, is also being marketed with Western engines. The American company Allison, although it had not signed a formal Memorandum of Understanding with Iliushin, jointly presented a brochure at the June 1993 Paris Airshow for a GMA 2100-powered Il-114, which could be ready for revenue service in 1996.¹¹⁴

Iakovlev produces Russia's most serious contender to enter the business/shuttle jet market — the Iak-40. Three of these regional liners are now going to be combined with Textron Lycoming LF-507 engines, as the first step in the partnership between the two firms. There is an estimated Russian market for as many as one thousand such aircraft,¹¹⁵ although there have been signs of the Iak-40, admittedly powered with Russian engines, not attracting the businessjet clientèle (see next section). Future projects of this partnership could include re-

¹⁰⁹ *Moscow News*, no. 7, 18-24 February 1994.

¹¹⁰ *Flight International*, 16-22 September 1992.

¹¹¹ *Aerospace Propulsion*, 9 June 1994.

¹¹² *Flight International*, 19-25 August 1992.

¹¹³ *Aviation Week & Space Technology*, 21 September 1992.

¹¹⁴ *Commuter Regional Airline News*, 14 June 1993.

¹¹⁵ *Air & Cosmos / Aviation Magazine*, no. 1393, 28 September-4 October 1992.

equipping the Iak-48 wide-body aircraft with LF-507 engines and Western avionics to make it a competitive regional jet airliner.¹¹⁶

Amphibious aircraft technology is an area in which Russia is particularly respected, and can hope to turn into profit. The T-101 remake of the An-2 has already been commented upon, but an even more ambitious project, with a strong element of conversion, is Miacheslav's T-102 (Iamal).¹¹⁷ The Iamal is being built by the Aviaspetstrans consortium, including Miacheslav, several research institutes, the Moscow regional Commercial Bank, and several government bodies. The project is expected to cost \$110m. Canadair have been approached for cooperation on the Iamal, as have Pratt & Whitney of Canada, the latter offering four free PT6 engines to test the prototypes.¹¹⁸ There are apparently already twenty orders for the T-102.¹¹⁹ Miacheslav has also approached Canadair on the possibility of serial production of their CL-415 twin-turboprop amphibian in Russia.

Moving now to joint projects in helicopter production, Kamov's scheme with Allison to power the Ka-226 with Allison 250-C20B turbines¹²⁰ appears to be the most concrete, the Western powered helicopter having flown in 1992. The Ka-226, aimed at both the domestic and foreign markets, will be marketed by the recently created Russian Helicopter Company Ltd.¹²¹

One venture which appeared for some time to be definite between Kamov, Rolls-Royce and Turbomeca had by mid-1993 to all intents and purposes been abandoned. The RR-Turbomeca RTM-322 powered Ka-62 medium-sized helicopter was supposed to have been certified in 1994,¹²² but this programme was halted, according to rumours reported by Rolls-Royce sources, because Turbomeca was forced out in order to protect the French helicopter market. If

¹¹⁶ *Aviation Week & Space Technology*, 21 September 1992.

¹¹⁷ For technical details, see *Air & Cosmos / Aviation Magazine*, no. 1389, 31 August-6 September 1992.

¹¹⁸ *Flight International*, 19-25 August 1992.

¹¹⁹ Presentation by Mrs. Baranova, Deputy General Director of the Aviaspetstrans consortium, during the 'Development of a Modern Air Transport Industry in the CIS' Conference, 13 May 1993.

¹²⁰ *Aviation International News*, 7 September 1992.

¹²¹ *Business & Commercial Aviation*, April 1992.

¹²² *Aviation International News*, 7 September 1992.

these rumours are true, this would be the first obvious case of covert protectionism against Russian commercial aircraft, yet a scenario which could easily become a common and serious threat to the rebirth of the Russian aeronautics industry.

Yet French involvement does not seem to have prevented Eurocopter, the joint venture where France's Aerospatiale has a majority holding and is coupled with Deutsche Aerospace's MBB helicopter division,¹²³ from reaching arrangements with Russian helicopter producers. The most developed project is with Kamov, with Turbomeca again appearing as one of the likely suppliers of engines (TP-319s) for the EC-150, competing with Allison 250s and P&WC 205s. Eurocopter were hoping for a 50% participation by Kamov and the Russian government, including half of the estimated \$165m research and development costs. If the expected demand for 3,000 such helicopters materializes, the resulting income to the Russian half would be over \$5bn. Eurocopter is also envisaging development of a helicopter project with the Mil Bureau and the Kazan works,¹²⁴ but by early 1994 progress on this project had been very slow, as all sides were finding it difficult to attract the necessary funding.¹²⁵

Other projects of this nature include Tupolev's plans to equip their Tu-330 with BMW/RR BR-715 turbofan engines;¹²⁶ and Aviastar Complex and Antonov's three-deck An-225 prototype.¹²⁷

¹²³ *Eurocopter — The Group*, marketing leaflet EI-002, June 1992.

¹²⁴ Interview with Christina Gotzhein, Manager of Public Relations, Eurocopter International, 8 September 1992.

¹²⁵ *Moscow News*, no. 7, 18-24 February 1994.

¹²⁶ *Flight International*, 19-25 August 1992.

¹²⁷ *Flight International*, 29 July-4 August 1992.

A1.6 Joint Production Partnerships with Western Enterprises, and the Most Marketable Areas of Russian Expertise

To provide pre-fabricated Western equipment to add onto Russian airframes is one thing; to invest in long-term joint production is quite another. Admittedly, there are many grey areas, most of all where there is a need for some degree of joint production to enable the coupling of Western and Russian technology to work. The importance of joint production or research is that, through technology transfer, or sometimes simply by creating an awareness of expected standards, it paves the way for Russian enterprises to be able to compete effectively in the international market.

The progress in joint production or research projects has been tremendous in the 1992-94 period. In 1992, any joint production projects were still at the hypothetical stage, and only a few tentative joint research programmes had been initiated. By the time of writing, however, and contrarily to expectations in 1992, there are many Western aeronautics companies who have braved the political risk and economic uncertainty, and committed themselves to long-term work with Russian counterparts.

The main sphere of joint production, so far, is in aero-engine development and manufacturing. For the same reasons that Western engines were chosen for export models of Russian planes, there have been two main approaches to joint projects: either producing a Western engine in Russia, or components thereof; or working jointly to improve Russian engine designs; in many cases, there are plans to do both. Apart from the obvious advantage of cost, another potential benefit of Russian-produced engines is that CIS airlines, if being supported by either governmental or IMF/IBRD financing, may well be put under some pressure to choose Russian/CIS engines.¹²⁸

The Russian company which has attracted the most attention for this type of project is the Perm'/Aviadvigatel' complex. Perm''s PS-90 turbofan is

¹²⁸ *Interavia Aerospace Review*, July 1992.

comparable in size and thrust to the PW2000 and RB-211, and it powers the Tu-204s and Il-96s which are not equipped with Western turbines. In negotiating a deal with Western partners, Perm appears to have played Western competitors very effectively against each other. The first joint enterprise involving Perm' which was discussed was one with the GE-Snecma joint venture CFM, in which CFM was to control 20% of shares.¹²⁹ By mid-1993, however, despite a statement in September by GE stating that it was still in the running,¹³⁰ Pratt & Whitney appeared to have secured the 'strategic joint venture' with Perm/Aviadvigatel'. Pratt & Whitney acquisition of Perm' Aeroengine Corporation stock is likely to have played a part in this, although to what extent is unclear.¹³¹ By the spring of 1994, P&W had stated that they would invest \$120-150m in a redesign of the PS-90 (the PS-90P) with some of the work being carried out by P&W's German partner, Motor und Turbinen Union (MTU). Pratt & Whitney are hoping for certification of the jointly produced PS-90 in late 1996. The joint venture is already evaluating projects to jointly develop next generation engines, possibly even to replace the PW2000.¹³² The clearest sign that this partnership is serious came in June 1994, when the Overseas Private Investment Corporation (OPIC, of the USA) granted P&W and MTU \$200m in political risk insurance.¹³³

Pratt & Whitney's sister company, Pratt & Whitney of Canada (P&WC), has been another leader in achieving joint production agreements. In August 1993, P&WC and the Klimov engine-building complex established a joint enterprise — P&W/Klimov Ltd.; this joint venture was registered by the Russian government in November. P&WC will hold 51% of the joint venture, the remainder being held by the Klimov Corporation.¹³⁴ P&W/Klimov will at first assemble and test PW200s and PT-6s, and although the volume of investment has not been specified, P&W/Klimov already have orders for Russian-produced PT6s

¹²⁹ *Air & Cosmos / Aviation Magazine*, no. 1385, 29 June-5 July 1992.

¹³⁰ *Aviation Week & Space Technology*, 13 September 1993.

¹³¹ *Moscow Tribune*, 26 May 1993.

¹³² *Flight International*, 18-24 May 1994.

¹³³ *BEE*, 4 July 1994, p. 9.

¹³⁴ *Aviation Week & Space Technology*, 20 September 1993.

from the joint venture between the Miasishchev Design Bureau and the Tec-Avia Management Group (Germany), for their twenty-four-seater MM-1. Development finance of \$100m has already been secured for the MM-1.¹³⁵ The PW300 has also been chosen by the joint project between Israel Aircraft Industries and Iakovlev, for their 'Galaxy' aircraft.¹³⁶

The development and marketing of engines is also the aim of a joint project between Textron Lycoming and the Soiuz Aero Engine Technical Complex (AESTC). In the short-term, the joint programme will concentrate on the production, certification and marketing of the Lycoming LF507, which is being offered for various projects to Tupolev, Sukhoi and Iliushin, and has already been chosen for the re-engining of the Iak-40 and Iak-48. Other projects being envisaged are on the Soiuz R126 regional turbofan, as well as the LF512 turbofan and LP512 turboprop. Soiuz, which produced the engines for the MiG-21 and MiG-27, should be a contender for US government conversion funds.¹³⁷

The other main Russian producer of powerplants for military jets, the Saturn Design Bureau, has also concluded a joint enterprise. The venture will be 80% owned by ABB (Sweden/Switzerland), and is to be called ABB Uniturbo. The joint venture aimed to manufacture components for power plants, to work jointly on engineering, as well as research and development.¹³⁸

Airbus Industrie, very possibly putting some of its Russian research work on light metals into practice already, has contracted Tupolev to provide titanium wing pylons for Airbuses. It is also evaluating the Tu-334 as a possible vehicle for a joint project with Tupolev, Alenia (Italy) and DASA (Germany),¹³⁹ and has even had talks with Aviastar about possible assembly work on future Airbus programmes, including the 600 and 800-seater concepts under study.¹⁴⁰

¹³⁵ *Commuter Regional Airline News*, 13 September 1993.

¹³⁶ *Air & Cosmos / Aviation International*, 9-15 May 1994.

¹³⁷ *Flight International*, 18-24 May 1994.

¹³⁸ *BEE*, 4 October 1993, p. 10.

¹³⁹ *Air & Cosmos / Aviation International*, 6-12 September 1993.

¹⁴⁰ *Flight International*, 29 July-4 August 1992.

Out of the Tupolev 204 re-engining programme led by BRAVIA, already a few genuine joint production ventures have been established. We have already seen that Hunting Aircraft will soon be producing aircraft interiors in Russia through the AVINTCO joint venture. More impressive is the fact that BRAVIA may not incorporate Rockwell-Collins' avionics in their production aircraft, as by then the Russian-American joint venture 'ARIA' (not to be confused with Aeroflot Russian International Airlines) may have sufficiently developed the BRED-IKBO ARIA-200 integrated system for it to run the RR-powered Tu-204.¹⁴¹

By the end of 1993, the EU had also become involved in aeronautics through TACIS. The 1992 Programme included two aerospace-related actions, both concentrated in the Moscow region. Mikoian was to receive consultancy and training worth 0.98mECU to assist in defining how, and to what extent, it should adapt its production and testing to enter the Western European and other international civil aviation markets. The second project from the 1992 budget, valued at 1.15mECU, was also aimed at a study of the non-military production capabilities of former defence manufacturer, the Lukhovitskii Machine Building Plant. The study was to identify products to be developed, and offer recommendations regarding adaptation of the corporate structure.¹⁴²

Of the three actions catered for in the 1993 TACIS Programmes, that supporting the 'Soiuz' Scientific and Production Association is very similar to those of 1992, providing 1mECU in assistance in drawing up a feasibility study of which branches of civilian technology this former specialist in rocket propulsion should focus on. The two other actions focus much more on one of the main problems pin-pointed in this appendix — the lack of compatible testing and certification standards. The federal Russian Action Programme, which includes the Soiuz project, also finances a 2.5mECU action to assist the Mil and Kamov helicopter producing bureaux in assimilating Western certification standards.

¹⁴¹ *Moscow News*, no. 7, 18-24 February 1994.

¹⁴² 'TACIS 1992 — Action Programme — Moscow', European Commission document, Brussels, 14 September 1992, pp. 9 and 37.

This project will concentrate in particular on reviewing the differences between Russian and JAR (West European Joint Airworthiness Requirements) technical and regulatory requirements, as well as recommending improved certification procedures.¹⁴³ The other 1993 project supporting aeronautics is to be found in the Western Siberia Action Programme. This 1.2mECU action is designed to assist the Novosibirsk Aircraft Industrial Association (NAPO — another former military aircraft producer) not only in the production and marketing of a light aircraft, but also in making its certification procedures compatible with those of the West. Some of the areas requiring reworking include test process qualification, certification of materials, sub-contractors, and suppliers.¹⁴⁴

This is a very impressive list of projects to have been accumulated in two years. Although the volumes of investment are relatively modest for the industry, most of these projects require investment upwards of \$100m — a good start by any measure. One fascinating aspect of these joint projects is that, despite the novelty and uncertainty of the situation in Russia, the aims are very ambitious. Whilst experts were predicting in 1992 that the first joint production projects were likely to be in the production of simple parts, such as casings and blades (China and Poland have been supplying similar parts to Western companies for over a decade), in fact Western companies have sought to tap Russian expertise to a greater degree, despite the complications involved.

Difficulties are bound to arise, quite apart from the common problems inherent to partnerships in Russia. The question of technology sharing is never an easy one; the same problems could be encountered which destroyed a much earlier joint programme between RR and GE, after RR refused to reveal an aspect of its technology which gave it a competitive edge.¹⁴⁵ Nevertheless, the pressure

¹⁴³ 'TACIS 1993 — Action Programme — Russian Federation', European Commission document, no date, pp. 23-24.

¹⁴⁴ 'TACIS 1993 — Action Programme — Western Siberia', European Commission document, no date, p. 18.

¹⁴⁵ Interview with Richard D. Ciochetti, Rolls-Royce's Chief Representative in Moscow; 1 June 1993.

of competitors also seeking deals to exploit Russian aeronautics potential has proven to be very strong, pushing executives to take a chance with Russian partners.

From the Russian perspective, it may be worrying that the first priority of these projects is to either supply parts for Western engines or aircraft, or produce Western engines in Russia; the execution of Russian ideas will come second, if at all.¹⁴⁶ This reflects a problem in the different approach of Russian and Western aeronautics specialists. The Russian aeronautics industry has been used to a very sectorized and theoretical approach, with little concern for the costs. Once the cost of materials gets closer to world prices, however, interesting ideas such as silicon-based blades or carbon-based turbine compressors (as have been developed in Russia)¹⁴⁷ are most likely to become more expensive than they are worth, especially considering the present depressed state of the aircraft market.¹⁴⁸

Nonetheless, the very high level of Russian scientific research has persuaded many Western aircraft producers to invest in R&D in Russia. With the standard of wages still a small fraction of those in the West, the opportunities are enormous. Boeing has been a pioneer in conducting such work in Russia, and has gone on to open their own research centre in Moscow, to employ only a few Boeing engineers and up to thirty Russians.¹⁴⁹

The TsAGI has also found many other foreign partners. Snecma has signed fourteen contracts for R&D in Russia, not only with TsAGI, but also with TsIAM (Central Institute for Aviation Metals) and MAI. Snecma is also planning a very large joint project on titanium. Hiring out facilities to Lockheed/General Dynamics and to Rockwell International is being negotiated; TsAGI still need more contracts to cover their cost, now that government funding covers less than half.¹⁵⁰

¹⁴⁶ See, for example, the problems of the Kuznetsov Bureau in *Air International*, July 1992.

¹⁴⁷ *Aviation Week & Space Technology*, 30 March 1992.

¹⁴⁸ Interview with Richard D. Ciochetti, Rolls-Royce's Chief Representative in Moscow; 1 June 1993.

¹⁴⁹ *Flight International*, 19-25 August 1992. and *Interavia Air Letter*, 17 August 1992.

¹⁵⁰ *Moscow Tribune*, 26 May 1993.

Airbus Industrie, as hinted above, is another Western company which has been conducting research projects in Russia. Discussions have been held with the All-Russian Institute of Aviation Materials (VIAM) to test light-weight lithium-bearing aluminium alloys, which could eventually be used on the new A330/340 family.¹⁵¹ Another area in which Airbus has done research with Russian specialists is cryogenic fuels.¹⁵²

Looking at know-how which will be needed in the longer term, Aerospatiale, the French component of Airbus, has also signed contracts for R&D with TsIAM and MAI research institutes for the French 'Prepha' hypersonic programme. The work they will be concerned with relates to 'superstato', an indispensable technology for hypersonic flight.¹⁵³ Research into hypersonic flight is being done on an important scale in Russia. Tupolev have begun bench-testing several structures for a new single-stage-to-orbit hypersonic aircraft, capable of speeds up to Mach 20-25. It is proving very difficult to find investors, however; France and Japan have been approached in particular, but these countries are already involved in their own hypersonic aircraft programme. Going beyond the role of contractor, as is being done by TsIAM and MAI, may prove to be very difficult in projects involving such state-of-the art technology. That having been said, joint space technology programmes between Russia and Europe, and Russia and the USA, show that sharing even the most sensitive technologies need not be impossible.

Other areas of aeronautics technology in which Russia's experience may prove marketable include the development of blimp-type aircraft. In a programme started in the mid-1980s, the ALA-40 'Thermoplane' is an ecologically clean vessel which should be able to carry five-six tonnes, and is only a prototype for the giant ALA-500, intended for 500-600 t cargoes. Suggested uses of this aircraft are as a fire fighting vehicle, as an emergency evacuation craft, or as a mobile hospital; in every case helped by the fact that it needs virtually no ground

¹⁵¹ *The Financial Times*, 12 June 1992.

¹⁵² For details of a joint Airbus and Tupolev study, see *Aviation Daily*, 9 June 1994.

¹⁵³ *Air & Cosmos / Aviation International*, 6-12 September 1993.

support. Western interest has been great, but no concrete cooperation projects have emerged.

The amphibious aircraft industry also has ambitious plans for the future, hoping to build on the experience of the Soviet military's 'ekranoplan' programmes, or wing-in-ground-effect (WIGE) cargo planes. A Virginia-based company is being funded by the US Defence Advanced Research Department to explore the possibilities of such aircraft, and has signed cooperation protocols with the Panchenkov and Alekseyev institutes.¹⁵⁴

Clearly, the potential for future cooperation is great. As costs and risks rise in aviation projects generally, and increasingly complex tasks require ever-higher levels of research, Western manufacturers are likely to seek many more such partnerships. It would certainly be a tremendous waste to have affordable yet top-class aeronautics researchers and facilities standing idle, whilst the aeronautical challenges of tomorrow beckon.

A1.7 Conclusions

Thus the competition is on between Russian and Western aircraft manufacturers, as it should be in an open market. Despite the various successes of Western companies in selling or leasing wholly Western-produced planes in the CIS, the best sign for the future of the aeronautics industry in Russia is that the same companies are investing in Russia, not merely in the production of components of Western aircraft, but more importantly in the production of aircraft which truly combine the abilities of Russia and the West.

It should be clear that the potential for Russia's aeronautics industry to increase its share of the global market is there. The projects described here have mostly been limited to those which are either confirmed, or have come close to it;

¹⁵⁴ For details, see *Flight International*, 11-17 March 1992.

there are many more again which are at a more informal stage, just waiting for the right conditions. With so many projects confirmed despite the uncertainties of investing in Russia, exponential growth of such cooperation can be expected when the political and economic situation stabilizes. As in other areas, this sector could also greatly benefit from a clear and enforceable legislative framework for investment and foreign trade, so that special concessions such as those granted to Pratt & Whitney in the Perm joint venture are not needed. Finally, there is a need for investment guarantees (such as that granted by the OPIC to P&W) to be much more forthcoming, a truer reflection of the confidence the Western aeronautics executives themselves have in the future of their Russian counterparts.

TABLE A1.1: Projects for Western Engines on Russian Airframes

AIRCRAFT	ENGINE MANUFACTURER	ENGINE MODEL	PROJECT STATUS
Beriev Design Bureau Be-103	Teledyne Continental	2 x IO-360-ES	engine as option
Iakovlev Design Bureau Yak-40TL Yak-48 Yak-242	Textron Lycoming Textron Lycoming International Aero Engines	2 x LF507* 2 x LF507* 2 x V2500	at proposal stage
Iakovlev / Israel Aircraft Industries Galaxy	Pratt & Whitney Canada	2 x PW305-7	development going ahead
Iliushin Design Bureau Il-76 Il-86 Il-96M Il-96T Il-96 Il-96 Il-103 Il-114A	CFM International CFM International Pratt & Whitney Pratt & Whitney Pratt & Whitney Rolls-Royce Teledyne Continental Allison	4 x CFM56-5C 4 x CFM56-5C1 4 x PW2337 4 x PW2337 2 x PW4084 2 x Trent 1 x IO-360-ES 2 x GMA2100	at proposal stage first stage of certification done orders secured (as for Il-96M) feasibility studies feasibility studies
Kamov Design Bureau Ka-62M Ka-62M Ka-62M Ka-226	Rolls-Royce Turbomeca LHTEC General Electric Allison	2 x RTM322 2 x CTS800 2 x T700/CT7-2D1 2 x 250-C20B	project on hold alternative to RTM alternative to RTM and CTS prototype has flown
Miasishchev Design Bureau T-102 (Iamal)	Pratt & Whitney of Canada	2 x PT6A	prototype being tested

AIRCRAFT	ENGINE MANUFACTURER	ENGINE MODEL	PROJECT STATUS
Miasishchev Design Bureau / Tec-Avia Management Group MM-1	Pratt & Whitney of Canada	2 x PT6A-67*	
Mikoyan Design Bureau MiG-Advanced Trainer (AT)	SNECMA Turbomeca	2 x modified Larzac 04R20	
Tupolev Design Bureau Tu-204/204-200C Tu-330	Rolls-Royce BMW / Rolls-Royce	2 x RB211-535E5/F5 2 x BR715	

* - to be produced in Russia

[Main source: *World Power Systems Intelligence*, 20 October 1993; updated and complemented with other sources quoted in appendix.]

TABLE A1.2: Projects for Joint Western-Russian Aeronautics Hardware Production, at Russian Facilities

Western Organization	Russian Organization(s)	Production Envisaged
ABB	Saturn Design Bureau	Production of engine components, R&D
Airbus Industrie	Tupolev Bureau	Production of titanium pylons
Daewoo	Klimov Bureau	Design of engines
Daewoo	Mil Bureau	Production of 5 t passenger helicopter
Daewoo	Kazan Helicopter Works	Design of helicopter airframes
Hunting Aircraft	Aerostar	Production of aircraft interiors
Israel Aircraft Industries	Iakovlev Bureau	Production of fuselage for Astra 4 (Galaxy) bizjet
Pratt & Whitney	Perm/Aviadvigatel'	Joint redesign of PS-90 turbofan; then next generation ones
Pratt & Whitney of Canada	Klimov Bureau	Assembly of PW2000 & PT6; then redesign others, e.g. TV-7-117
SNECMA / Turbomeca	Mikoyan Bureau; Klimov Bureau	Production of powerplants for MiG-AT trainer jet
Textron Lycoming	Soiuz Complex (AESTC)	Production of LF507; later Soiuz R126, LF512 and LP512
'ARIA' Russian - American joint venture		Production of avionics for RR-powered Tu-204

Appendix 2: Oil and Gas as an Example of the Potential for Increased Russian Commercial Interaction with Western Europe

A2.1 Importance of Sector

The oil and gas sector is not only of fundamental importance to the Russian economy's ability to play a significant role in the global economy as a whole, it will also become an ever more weight-bearing pillar commercial interdependence with the EU states.

The disadvantage of this is the vulnerability that comes with dependency on one particular market for exports, in this case oil and gas, which was demonstrated during the 1986 drop in oil prices. The overall value of Soviet exports to the industrialized West dropped 29.3% from the previous year to Rb13.1bn in 1986, thus burdening Moscow with a Rb2.7bn (hard currency) trade deficit with the industrialized West. In terms of hard currency exports to the industrialized West, crude oil and oil products decreased by \$4.8bn (or 37.9%) to \$7.9bn in 1986, whilst gas export earnings from the OECD market decreased slightly (\$3.80bn from \$3.40bn) despite a 26.7% increase (to 38 bcm) in the volume exported.¹ As a proportion of total hard currency export earnings (that is, not only from the OECD), despite energy export revenue having recovered at over \$13bn, they still represented only 51.5% of hard currency export revenue, compared to 66.6% in 1984. By 1989, Smith estimates that, at \$12.7bn, fuels represented 43.1% of hard currency exports.² The proportion of exports to the EC which consist of hydrocarbons is considerably higher. In 1990, the \$12.3bn in

¹ Alan Smith, *Russia and the World Economy — Problems of Integration*, London, 1993, p. 80; based on a combination of OECD and Vneshtorg figures.

² Alan Smith, 1993, op. cit., p. 143: these figures are only approximations, however; to give one example, figures for energy exports to OECD countries only have in some years been higher than the total for hard currency gas and oil export earnings, for example in 1989, when they were calculated at \$14,053m and \$13,268 respectively. The same trends are nonetheless reflected in both tables.

fuel exports to the Twelve (or \$15.3bn if the former GDR is included) represented 62.2% of total exports to the Community (or 60.3% if the ex-GDR is added); in 1991, \$12.7bn or 58.6% (including the Eastern *Länder*); and in 1992, \$12.7bn or 57.7%.³

In terms of hard currency earnings, according to Russia's Minister for Fuel and Energy Iurii Shafranik, Russia's dependence on the energy complex had increased by 25% in the first quarter of 1993 alone.⁴ Crude oil exports (excluding oil products) from Russia to outside the FSU in 1992 managed to climb to over 66 mt, a 17% increase on the 56 mt dispatched in the previous year,⁵ and in 1993 this increase continued, with a 62% increase in crude exports (reaching 11.8 mt) in January and February compared to the same period in 1992. Natural gas exports for the same period increased even more, by 24% to 15.5 bcm.⁶ This has been possible, despite falling volumes of production of both oil and gas, most of all because of Russia's new-found freedom in choosing whether to keep its oil in the FSU or to export it further afield. Exports from Russia proper are much higher than the figures for the FSU; for example, in 1988 oil and petroleum products leaving Russia amounted to 295 mt (as opposed to 183 mt for the USSR), and 193 mt in 1991 (97 mt for the USSR);⁷ these figures show that Russia has not avoided a decline in oil sold outside its borders, but can merely disguise it by using figures which conceal the reduction in exports to former Soviet republics.

In the near future Russia has little choice but to exploit her undeniable comparative advantage in energy production. The size of Russian energy reserves is truly impressive. Despite the fluctuations in production, Russia has remained the world's largest extractor of oil. From an output of 491 mt in 1975, Soviet oil

³ *International Trade 1993 — Statistics*, GATT, Geneva, 1993, p. 25; these statistics have the advantage of being based on Western figures, and not comparing energy products with other goods priced in soft currency, or which may have been bartered.

⁴ *Moscow News*, no. 24, 11 June 1993.

⁵ *My*, no. 11, June 1993; and *Oil and Gas*, no. 3, 1993.

⁶ *Kommersant*, 23 march 1993.

⁷ P. Godec, 'La situation pétrolière dans l'ex-URSS: l'évolution récente, les perspectives', February 1993; copy given by author.

production increased every year until it reached 616 mt in 1983.⁸ After dropping to 595 mt in 1985, production again increased to an all-time high of 624 mt in 1988 following large-scale investment and unfortunately for long-term production, short-sighted approaches to immediate extraction which reduced the potential total capacity of many reservoirs. Yet even these measures could not prevent another decline in production to 607 mt as early as 1989, plummeting further to 570 mt in 1990.⁹ Although the above figures refer to production in the USSR as a whole, Russian output accounts for the vast majority of this; for 1993, Russia's oil output was expected to be 86.7% of FSU production (357.5 mt out of 412.5 mt¹⁰). In fact, however, production in 1993 was yet another disappointment; after having fallen to 384 mt in 1992, Russian production shrunk further to 333 mt in 1993.¹¹ Explored reserves, upon which to base expectations of future production, have not been a basis for hopes of a return to the levels of production of the mid-1980s. British Petroleum has estimated the R/P rate (explored reserves ratio to that of production) at 13, whilst Petroconsultants have estimated it at 10 in 1985.¹² Although these rates are similar to those of the USA, in relation to the reserve levels of the 1970s they are discouraging, especially when considering that the different classification system in calculating reserves in the FSU probably overstates these figures, in relation to Western ones. Yet many experts believe that such low reserve estimations are misleading. Exploration has been a low priority in the Soviet oil industry in the late 1980s, representing only 18-19% of total drilling efforts, and it tends to be of poor quality; seismic surveys in the USSR were supposedly only 20% as efficient as those of the USA.¹³ An

⁸ Jonathan P. Stern, *Soviet Oil and Gas Exports to the West*, Aldershot, 1987, p. 83, and Marshall I. Goldman, *The Enigma of Soviet Petroleum — Half-empty or Half-full?*, London, 1980, p. 64.

⁹ Arild Moe, 'The Soviet Oil Industry: Where Do We Go From Here?', in *The Soviet Economy Under Gorbachev*, NATO Colloquium 1991, Brussels, 1991, p. 82.

¹⁰ *Moscow News*, no. 24, 11 June 1993, based on information from the School of International Business of the Moscow State Institute of International Relations.

¹¹ OECD stats, 1994, p. 80

¹² Arild Moe, op. cit., p. 87; taken from, respectively, the BP Statistical Review of World Energy, July 1989, and Soviet Geography, November 1987, p. 630.

¹³ Arild Moe, op. cit., p. 87, from *Stroitel'stvo Truboprovodov*, no. 12, 1988, p. 1.

increase in the amount and quality of exploratory work could well restore a very enviable R/P ratio to the Russian oil industry.

Even despite the inadequacies of its exploration data, Russia can clearly claim to have the world's largest natural gas reserves, already accounting for approximately 40% of global proven reserves. Seven of the world's ten largest gas fields are to be found in Western Siberia. By the end of the century, the CIS gas industry (of which over 80% is expected to originate from Russian territory¹⁴) could well be producing 1,000 billion cubic metres (bcm) per year.¹⁵ Already by 1990 the USSR was producing 850 bcm, almost double the 435 bcm figure for 1980. By 1992, however, gas production for the FSU had decreased to 788.1 bcm. Although the rate of increase in gas production has levelled off from around 10% p.a. in the early 1980s to a slight decrease in 1991-92,¹⁶ the reason lies in lack of investment capital, not in the lack of accessible gas. A report by the Cambridge Energy Research Associates notes that the sheer size of resources is not the only reason for the gas industry escaping the depressed state of the oil industry; the fact that there was less need for sophisticated technology, the smaller scale of the needed workforce, and the creation of an independent yet still monopolist ruling body in Gazprom are all factors which have enabled gas production to remain high.¹⁷ The importance of gas in relation to oil had also been on the increase; by 1990 gas output in the CIS had overtaken oil production, in terms of standard fuel equivalent. Russia's own gas production was of 254 bcm in 1980, 589.8 bcm in 1988, and 640.6 bcm in 1992;¹⁸ the slow-down in production has thus been less in Russia, for example, production being up 8.6% between 1988 and 1992, compared to 2.4% for the FSU as a whole.

Of equal importance to the supply of oil and gas, in determining how much energy Russia has at its disposal for export, is domestic demand. Only if Russian

¹⁴ According to tables provided by the Russian Ministry of Energy and Fuels, April 1992.

¹⁵ Jonathan P. Stern, 1987, op. cit., pp. 8-9.

¹⁶ *Oil and Gas Russia*, no. 1, 1992, p. 97; *Ekonomika i zhizn'*, no. 5, 1991, gave a lower gas production figure for 1990, however, at 815 bcm.

¹⁷ *Russian Petroleum Investor*, April 1992.

¹⁸ *New Markets Monthly*, October 1993, p. 5.

demand for gas and especially for oil can avoid growth, and energy wastage be reduced, can Russian oil and gas exports play the role they should. An underestimation of the importance of local consumption, and of its elasticity, has been a main cause of the inaccuracy of many forecasts of Russian energy exports. The most famous case is the prediction by the CIA in 1977 that by the mid-1980's the USSR would have to import oil to satisfy CMEA needs. This estimation turned out to be remarkably far from the truth, the USSR actually managing to export 81 mt of crude oil to OECD countries in 1984, and 67 mt in 1985. The CIA's estimation was spectacularly wide of the mark partly because it underestimated Soviet oil production by 100-200 mt, but mostly because it assumed that the Soviet economy would continue growing, and wasting energy, at a fast pace, resulting in a growth in energy consumption of 2-3% p.a.. In fact Russia managed to cut the growth rate of energy consumption during this period, and increase the proportion of oil exports going to OECD countries (from 36.7% of total exports in 1975 to 45.5% in 1984).¹⁹ This tendency has become even stronger, as domestic energy prices became ever closer to world prices in the first six years of the 1990s.

The internal demand for oil is a very important issue, as the export market conditions are much more favourable to oil than to gas, although this could change towards the end of the century. In order to free oil for export, Russians have long tried to substitute it with other fuels.²⁰ Most common has been the oil-to-gas switch, which has proved to be the most logical solution as gas output has boomed; many coal-burning power plants were also converted to gas in the 1980s. Soviet gas consumption nearly doubled in the period from 1980 to 1990; in the last six years of this period, electricity generating accounted for 60% of the new gas. Yet despite a lack of lighter oil products, oil-to-gas substitution will not be able to continue increasing much until the end of the decade, due to a lack of capital for the re-equipment needed for this conversion, unless foreign investment

¹⁹ Jonathan P. Stern, 1987, *op. cit.*, pp. 92-96, and Marshall I. Goldman. *op. cit.*, p. 113.

²⁰ Jonathan P. Stern, 1987, *op. cit.*, p.10.

is found.²¹ Although in both power stations and industrial boilers substitution of gas for oil is not technically difficult, it involves infrastructure problems, and in particular new pipeline connections to a large number of separate units. Germany's Ruhrgas became involved in one such project in early 1993, providing DM10m worth of financing for its first phase, the delivery of natural gas processing and distribution systems to five Russian cities, through Rosstroigazifikatsiia.²² Yet in some cases even the success of substitution is problematic; the Soviet refining capabilities cannot cope with all the freed fuel oil (mazut), which needs to be converted to lighter and more valuable hydrocarbons; it has been argued that the 1982-84 surge of Soviet mazut exports to OECD countries was due at least in part to the freeing of fuel oil from power stations.²³

It is barely within Russia's means even to minimize the decline of its oil industry, let alone to hope for increases in production; of the 45 mt which had been offered for export, the revenues from 25 mt were needed for essential oil equipment, according to Mintopenergo figures.²⁴ Luckily for Russia, the gas industry may be able to take over as the golden egg-laying goose. Already in 1991, gas exports from Russia had almost reached that of oil and oil products, reaching 1.7 mt of oil equivalent.²⁵ This extremely young industry (in 1974 the USSR was still a net importer of natural gas) may well be producing as much as the gas output of the rest of the world put together by the end of the century. Assuming that the necessary capital can be found for extraction, the main question is whether demand can be found abroad for this gas; if so, the 70:30 balance of oil exports to gas exports which applied in the mid-1980s should have been reversed by the year 2000.²⁶

The remainder of this appendix will explore in greater detail, focusing on the period between 1991 and 1993, the factors which will determine the future

²¹ *Russian Petroleum Investor*, April 1992.

²² *BEE*, 8 February 1993, p. 12.

²³ Jonathan P. Stern, 1987, op. cit., p. 12.

²⁴ *Kommersant*''', 23 March 1993.

²⁵ *Russian Petroleum Investor*, April 1992.

²⁶ Jonathan P. Stern, 1987, op. cit., p. 70.

level of energy trade between Russia and Western: the restrictions which have traditionally limited exports to, and investment from the West; the spheres in which Russia has the greatest need of European assistance; the aspects of the Russian energy market which make it a tempting prospect for Western investors; the main barriers yet to be broken in order to allow truly significant levels of investment and know-how to flow in from the West; and finally the main hopes for the future.

A2.2 Previous Restrictions on Foreign Involvement in Oil and Gas, and New Conditions Allowing Western Cooperation

The pre-*perestroika* possibilities for Western companies to open subsidiaries and operate for profits or royalties were simply nonexistent. By the end of the Second World War, the last of the few Western firms which had been allowed to operate since NEP had been forced to leave.²⁷ This does not mean that Western companies were to remain totally excluded; many of the problems of extraction and transportation of fuels, for which Western partners are now being sought, were already being tackled with the help of Western technology in the 1960s and 1970s. There were of course the gas pipes being offered by West European countries, at first in the early 1960s for the 'Druzhba' pipeline, and those supplied in the early 1980s for the 'Progress' pipeline.²⁸ Other examples of early acquisition of EC oil and gas technology included a contract with a French firm to install a gas lift system (explained below), one with Italy's Pressindustria to build

²⁷ Marshall I. Goldman, *op. cit.*, p. 128.

²⁸ Jonathan P. Stern, 1987, *op. cit.*, p. 27.

a plant to produce non-ionic surfactants to enhance recovery in water-logged reservoirs, and an arrangement with West Germany's Borsig to provide two carbon-dioxide liquefaction plants, used like gas to increase pressure in reservoirs.²⁹ Although many of these projects were enormous and surely very lucrative, the European partner was nonetheless restricted to the role of contractor.

In pre-Gorbachev days, it was not only Moscow that put up barriers to Soviet-EC trade in energy. In the mid- to late 1950s, despite a rapid increase in oil production, the Soviets did not manage to increase exports, due mainly to the fact that all the major oil companies were boycotting Soviet crude oil. The breakthrough came when the Italian state oil company ENI, which was challenging the established major oil companies, imported nearly 5 mt of Soviet oil in 1960, and soon afterwards a barter deal with India helped to accelerate the demise of the boycott on USSR petroleum.³⁰

A much more direct intervention against the Soviet energy sector came in 1962, when Western companies were to assist in the completion of the 'Druzhba' pipeline to Eastern Europe, but were severely restricted by CoCom regulations of the same year which forbade the export of the largest diameter pipes to the USSR. It is worth noting in this context that, although there was an undoubtedly strategic element to this decision, it was also clear that American oil companies had much to gain from this stranglehold on the development of Soviet energy exports.³¹

Despite the restrictions, pipeline equipment firms from Belgium, Britain, France, Holland, Italy, the Netherlands and West Germany (to name but the EC partners) became involved in business with the USSR, creating serious disagreements in 1978 amongst Western allies, when President Carter imposed yet stricter sanctions (on human rights' grounds) on sales of oil and gas drilling equipment. Tensions were raised further when President Reagan increased American pressure and sanctions were enacted, first following the invasion of

²⁹ Marshall I. Goldman, *op. cit.*, pp. 121-24.

³⁰ Jonathan P. Stern, 1987, *op. cit.*, pp.26-28.

³¹ *Ibid.*, p. 27.

Afghanistan, and then the imposition of martial law in Poland, just as Western companies had mostly finalized their contracts to supply the Urengoi-Western Europe gas pipeline. American sanctions against the USSR were to cover equipment produced under US licence by West European firms for the compressor stations of this East-West gas pipeline. This time West European countries refused to comply. The French government went as far as to order Dresser-France, an affiliate of Dresser-USA, to respect its contracts to the USSR, supported in this by a statement of the EC Commission considering that this extra-territorial application of American law was not binding.³² The Americans finally agreed to the compressor-equipment deals going ahead, and to Western Europe receiving important amounts of Soviet gas (although this was to be limited to a maximum of 30-35% of total gas usage of any US ally).³³ There were to be no more energy equipment crises in the 1980s, but the petroleum and chemical equipment section of CoCom's Industrial List remained in place, playing its role in limiting the development of Soviet oil and gas production.

Nonetheless, as Soviet energy exports to the EC increased in the early 1980s whilst consumption decreased, thus increasing EC dependence on Soviet oil and gas, no counter-measures were taken. Not only contractual agreements increased, but Soviet supplies to the growing spot market (one-off sales of fuel, not part of long-term contracts) in Europe were also increasing. As Gorbachev's reforms had calmed tensions between East and West, EC companies found no obstruction from their own countries when attempting to take advantage of the new trade conditions.

As with the rest of the Soviet economy, the Soviet energy sector was to become more open to foreign participation through *perestroika*. The movement towards 'joint ventures' was to include the oil and gas industries as well, with Phibro of Switzerland and Canadian Fracmaster amongst the first Western energy companies to form JVs. The next step, as explained in chapter three, was the

³² Marie Lavigne, *Economie internationale des pays socialistes*, Paris, 1985, p. 168.

³³ Peter Hanson, 1988, op. cit., p. 46.

possibility to open wholly owned subsidiaries. In the oil and gas sector, however, exceptions to the rules applying to the rest of the economy were imposed, leaving Western oil and gas investors even more confused than those in other sectors. To attempt to clarify the situation, the Russian government passed the Law on the Subsurface in February 1992, stressing the distinctiveness of the oil and gas sector. This law did give the subsurface user the right to 'use the products of his activity', in other words fuels were out of the state's control once extracted; however, the law avoided the issue of actual ownership, specific rights of foreign investors, or rights of export.³⁴ At the time of writing, the passing of a Law on Oil and Gas, to complement the Law on the Subsurface, was eagerly awaited, but already expectations of this new law's impact on foreign investors' confidence has been lowered.

Yet the number of projects involving Western oil companies slowly rises, partly due to the currently preferred method of tendering out the right of access to particular fields, usually for a substantial price;³⁵ as we shall see later, this process has attracted criticism, but it does at least show that there is still a desire among the Russian authorities to attract foreign energy enterprises. Another gesture towards encouraging new energy investment has been to draw up a list of 120 fields with tax benefits, enabling the producer to export 60% of extracted oil, without paying export tax. Although this is basically aimed at Russian producers, it is thought that when fields on this list are offered out to tender, for example the Poluniakh and Tailakov fields on offer in the Khanty Mansiisk tender, the Western producer may well have the same benefits.³⁶

In effect, the current situation is one where theoretical opportunities for successful investment in Russian energy are many, yet the actual feasibility is far from clear. It is a game of trial and error, until firmer legislation is in place; only by achieving precedents are the limits of true possibility unveiled. Oil and gas companies are so far investing relatively small amounts of capital, ready at this

³⁴ Law of the Russian Federation on the Subsurface, in *Oil and Gas Russia*, vol. 1, no. 1, 1992.

³⁵ *Russian Petroleum Investor*, April 1992, and *The Financial Times*, 29 September 1992.

³⁶ *Petroleum Economist*, April 1993.

stage to be paying for the lessons rather than for fuel; the multi-billion dollar projects which are discussed refer to long-term investment which will only be fully spent once profitability has been proved. One of the main success stories of this period from an EC firm is the deal reached by France's Elf Aquitaine for the right of exploration and exploitation of an area in the pre-Caspian basin, between Volgograd and Saratov. In mid-1989, during Gorbachev's visit to France, Elf was offered a ready-to-sign agreement for a 50-50 joint venture, but the French company refused, not wanting to share the responsibility for exploration. Nonetheless, they immediately pursued new negotiations. In May 1990, Elf managed to reach General Agreements with the USSR Ministries of Petroleum and of Geology, allowing access, on a joint production basis, to these two areas,³⁷ which led the way to the signing of an exploration and exploitation contract in February 1992, supported by a presidential decree.³⁸ Due to the uncertainty of regulation and the political instability, Elf insisted on having the contract ratified by the Supreme Soviet as well, as it contained clauses, particularly in relation to fiscal arrangements, which went against legislation being prepared by the Russian government. Elf's contract explicitly avoids separate export or other taxes, Elf's contribution being a predetermined proportion of revenues: first a royalty of 12.5 % is deducted before sharing the oil; 45% of what remains goes to Elf, as 'cost oil', until investment outgoings are recovered; a further 10% will be put aside in case a new pipeline must be built; of the remaining oil, in other words the 'profit oil', Elf has 40% of production on up to 100,000 barrels per day (b/day), then a sliding scale down to 15% on 400,000 or more b/day.³⁹ Elf's Russian subsidiary, Elf Neftegaz, decided early on to create a joint stock company specially for the Volga-Saratov project in order to untie certain bureaucratic knots, especially with the export of oil.⁴⁰

³⁷ P. Godec, op. cit.

³⁸ According to ITAR-TASS World Service in English — from *SWB*, Weekly Economic Report, 14 February 1992.

³⁹ *Petroleum Economist*, April 1993.

⁴⁰ Interview with P. Godec, General Director of Elf Neftegaz, on 18 March 1993.

Thus success can be achieved, and Elf is by no means the only company to have managed an agreement; Phibro, Canadian Fracmaster, Occidental and others are at an even further stage, having already achieved production. Conoco and Gulf Canada are two of the companies who have managed to secure deals which similarly exclude obligation to pay export duties, and France's Total managed to copy Elf's sliding scale of the proportion of produced oil to be kept.⁴¹ What this example also shows, however, is that there is no clear-cut or sure way of successfully reaching an agreement. The section on pitfalls comes later, and unfortunately there is much more to be said there.

A2.3 Most Promising Sectors of Cooperation

The fact that there are so many obstacles left in the way of potential West European investors is certainly not caused by a lack of necessity for cooperation. The deficiencies in the Russian energy sector are overwhelming, and the following areas are merely the most pressing where EC and other developed countries' assistance is required.

The most basic insufficiency is capital; the vast amounts needed for the exploitation of large oil or gas fields are simply not available now that prices for oil and gas machinery is approaching world levels much faster than Russian energy prices. Russian state investment has plummeted; government capital has almost disappeared, and enterprises' own investments have been restricted by low gas wholesale prices, high taxes, and a very low percentage of hard currency earnings being retained.⁴² In early 1993, the Minister of Fuel and Energy estimated that \$4-5bn was needed in that year simply to stop production falling below 340 mt.⁴³ Elf's General Director believed that it would take investments of \$12bn p.a. for ten years to bring production back to 450 mt in 2003-04, after a

⁴¹ *Arguments and Facts International*, August-September 1992.

⁴² *Russian Petroleum Investor*, April 1992.

⁴³ *Petroleum Economist*, April 1993.

low of 250 mt in 1995-96. If a return to the levels of 1988-89 was to be aimed at, Godec foresaw that an impossible \$20bn p.a. for ten years would be needed, taking only Russia into consideration. Even with the best conditions and intentions, such amounts would not be forthcoming, and the present uncertainty is likely to keep the inflow of capital at a tiny fraction of what is needed. This is deplorable, when over 15-20,000 wells stand idle, with no equipment or capital to repair them, and the number of such wells increases by around 10% p.a., representing a loss of 30-50 mt p.a..⁴⁴ Another reason for the great shortage of money in the energy sector is that it has suffered particularly badly in the debt crisis; in mid-1992, the complex was owed Rb525bn, whilst it owed others Rb386bn.⁴⁵

Although the conditions are far from ideal, and foreign capital could increase exponentially if confidence in the Russian investment climate was to grow, there are finally signs that some sizable sums are being committed. Looking merely at some of the most important involvements of EC firms, there is of course the Elf project described above, which has a stated minimum investment of \$500m over at least nine years; some estimates of the likely total investment (the concession is for a maximum period of twenty years) are as high as \$4bn.⁴⁶ Another French oil company, Total, is likely to invest \$1bn in the technical refurbishment and development of Khariaginskoe field in northern Russia. In an earlier deal British Gas, together with Gulf Canada, became involved in a project in the Komi area which may well call for \$875m of investment.⁴⁷ Of the capital injections from multilateral agencies, the most recent and substantial is a \$610m loan granted by the World Bank, targeted at the restoration of 1,300 wells and the replacement of over 1,000 km of pipeline in Siberia.⁴⁸ The EBRD also has substantial involvement in the sector, acting successfully as a catalyst for further capital flow. The first such project is for enhanced recovery in existing oil wells

⁴⁴ P. Godec, op. cit.

⁴⁵ *The Financial Times*, 23 September 1992.

⁴⁶ *Eastern Bloc Energy*, April 1993.

⁴⁷ *Central European*, September 1991, p.20.

⁴⁸ *The Financial Times*, 14 August 1993.

in Western Siberia, involving Canadian Fracmaster and Samotlorneft; the EBRD loan is \$9.8m, which should have led to over \$20m in subordinated loans.⁴⁹ Second is a \$30m EBRD loan, with an option to extend by a further \$10m, offered to the Chernogorskoe joint stock company (consisting of Chernogorneft A. O. and Anderson/Smith Overseas Inc. [U.S.A.]); this loan, also to develop the Samotlor area, was accompanied by \$44m credit from Morgan Grenfell, guaranteed by the US Eximbank.⁵⁰ The EBRD also agreed to finance part of Conoco's Polar Lights project in the Arkhangelsk province, the Bank's \$90m loan triggering off a further \$50m from the Overseas Private Investment Corporation,⁵¹ and another \$60m from the International Finance Corporation (IFC — affiliated with the World Bank).⁵² These commitments are definitely a move in the right direction, but bearing in mind that the amounts quoted are for the total duration of usually very long projects, and comparing the figures with the estimated needs of the industry, it is clear that there is much hard selling yet to be done by the Russian government. The most important selling point which the Russian government must be ready to offer EC/EU investors if they are to be attracted to the oil and gas sector, it must again be stressed, is a predictable and affordable tax policy.

The lack of capital described above translates into a lack of equipment. It is true that the recent shortage of expenditure on the energy sector is not the single reason for insufficiency of technology; for three decades now experts have been criticizing the Soviet authorities for putting too little emphasis on producing more and better tools of extraction. Even in 1979, E. Khalimov, then Deputy Minister of the Petroleum Industry, claimed that only 2% of the necessary equipment was being produced in the USSR.⁵³ This lack of sufficiently advanced home-grown technology is hurting the Russian economy ever harder, as new conditions require

⁴⁹ 'Russia Federation. Samotlor Pan-Canadian Fracmaster Services Joint Enterprises', EBRD document no. BDS92-121, 30 October 1992.

⁵⁰ 'Morgan Grenfell Banking News Update no. 17', 18 June 1993.

⁵¹ *Eastern Bloc Energy*, April 1993.

⁵² *The Moscow Tribune*, 3 July 1993.

⁵³ Marshall I. Goldman, op. cit., p. 124.

increasingly complex instruments. The situation is made worse still by the fact that with decentralization many oil and gas equipment producing enterprises have switched to the production of more profitable consumer production, and/or have massively raised prices of their equipment, to levels often both unaffordable and uncompetitive in relation to their Western competitors.⁵⁴

An example of lost opportunity is in the gas lift process, in which the Soviets did much of the pioneering work, but never developed the capacity to produce the required equipment in sufficient quantity. Since the 1970s, when the Soviets began to buy Western gas lift systems, the need for these systems has rocketed, as the newly prioritized fields in Western Siberia responded very poorly to water injection which had worked adequately in the Volga-Urals region. Drilling in the 1990s is increasingly complicated, as most of the new layers of gas and oil to be aimed at are much deeper, in reservoirs of much higher pressure, and where the gas is often liquid, thus also requiring Western equipment for the re-injection of gas.⁵⁵

Exploration is another area in need of Western involvement. As mentioned earlier, explored reserves of oil in Russia have come down to levels which are unnecessarily low, in part due to the fact that Soviet seismic studies are judged to be only 20% as efficient as Western studies.⁵⁶ Again, a lack of foresight is also to blame. The central planning system coped poorly with the need for extensive exploration, as there were few incentives to locate new oil reserves; the number of exploratory wells drilled actually declined from 5,802,000 in 1967 to 5,418,000 by 1975.⁵⁷ In geographical areas offered to Western companies, exploration occurs *de facto*; the habitual form of the tenders now being offered on certain fields is of a licence to prospect for and survey oil and gas fields, and only subsequently can joint production be agreed upon.⁵⁸ In these cases the standard of exploratory data is often much higher than what the Russians require, the

⁵⁴ *Russian Petroleum Investor*, April 1992.

⁵⁵ *Russian Petroleum Investor*, April 1992.

⁵⁶ Alrid Moe, NATO Colloquium, op. cit., p. 87.

⁵⁷ Marshall I. Goldman, op. cit., p. 122.

⁵⁸ *Arguments and Facts International*, August-September 1992.

minimum being dictated by a project's financing institutions.⁵⁹ It would be wise, however, to aim for a much broader involvement of Western enterprises in large-scale exploration, not merely in the minority of fields with foreign involvement. An increased R/P ratio would increase the magnetism of the Russian energy sector to EU and other investors.

The requirements for gas pipelines, which caused the political turmoil described in the first paragraphs of this section, are continuing. By having to use an inadequately small number of Russian or Czech 25Mw compressors (as not enough were available), or simply using less powerful ones,⁶⁰ large pipelines have run into problems that now require major expenditure on Western equipment; for example, Britain's Rolls Royce, a regular purveyor of gas equipment to Russia, only recently secured another order, worth \$210m, for thirty gas turbines for a section of pipeline in Western Siberia.⁶¹ Western gas equipment suppliers are likely soon to have orders of much greater magnitude, as a new pipeline to Western Europe is planned. Justified by the expected increase in European demand for gas, and by the problems with transmission through Ukrainian territory, at least one pipeline of 56 inches in diameter is to be built from central Russia, through Belarus' and Poland to Germany.⁶² According to Fuel and Energy Deputy Minister Anatolii Shatalov, Poland and Belarus' are supportive of the 'Iamal-Evropa' project, and have each agreed to purchase 5 bcm of gas from it yearly.⁶³ Although there are projects to improve Russian production of pipelines and compressors, if the pipeline is to be built soon it is likely that the vast majority of these parts, and the machinery to install them,⁶⁴ will be purchased from the EU and the USA.

⁵⁹ Interview with David Denton, Manager of Marathon Oil Co.'s Russia Representation, 1 June 1993.

⁶⁰ Jonathan P. Stern, 1987, *op. cit.*, p. 8.

⁶¹ *The Petersburg Press*, no. 8, 29 June-5 July 1993.

⁶² *Russian Petroleum Investor*, April 1992.

⁶³ *Moskovskie novosti*, 27 June 1993.

⁶⁴ In this context, the US Eximbank has provided \$14.5m in credit to Gazprom for the purchase of American 'Caterpillar' pipeline installers, a company traditionally preferred by Russia. This credit, and an accompanying \$72m loan for other Caterpillar purchases, has been criticized for its effect on the Russian 'Cheboksarets' company, also producing pipeline installers and bulldozers, at around one tenth of the price; see *Moskovskie Novosti*, 27 June 1993, and Marie Lavigne, *op. cit.*, p. 167.

A2.4 Main Barriers to Cooperation Yet To Be Lifted

The number of factors discouraging potential Western partners is evidently still far too large. A clear sign of this is that in 1992 only 4.5 mt of oil, or 1.1% of Russia's total output, came from joint enterprises with foreign participation, and in 1993 it was expected to be 7.5 mt, that is approximately 2%.⁶⁵

We have already noted that the Law on the Subsurface was of very limited effect, and that the complementing Law on Oil and Gas was still being awaited at the time of writing. The delays and shifts in position over this draft law are indicative of the ambiguous attitude of the Russian authorities towards Western involvement in their oil and gas industries. Despite very many Western experts being brought in to help draw up these drafts, often at very great expense by IFIs, very few of the recommendations have been kept in later versions of the draft.⁶⁶ Many believe that the problem is not only with the conservative majority of the Russian parliamentary assemblies, but also that even within El'tsin's government there are many elements who wish to keep the stress on protectionist measures; Prime Minister Chernomyrdin is said to have held that opinion, as is Aleksandr Perchik, head of the working group on the draft law.⁶⁷

One of the main aspects of the confusion for foreign investors, and an important part of the problems delaying the ratification of the Law on Oil and Gas, is the conflict between Russian federal authorities and regional bodies. The problem of not knowing with whom to reach a valid contract still exists, the jurisdictions still not being clear. Interviews with representatives of companies successful in completing the first stages of projects suggest that the key is to agree on a project proposal with regional authorities first, and then the regional branch of the relevant federal body, before approaching the Moscow bureaucrats; there

⁶⁵ *Petroleum Economist*, April 1993.

⁶⁶ *Petroleum Economist*, February 1993.

⁶⁷ *Kommersant*''', 1 June 1993.

will often be a willingness to comply with a project upon which regional cadres have already set their hearts. This view is supported by Gaidar in his speech to the Heritage Foundation in Washington: 'You should go to the factory, you should go to the regional state committee, you should probably go to the regional government, but not to Moscow'.⁶⁸ Nonetheless, the extent of powers granted to local and regional authorities, which will have to be extensive to be accepted by them, needs to be clarified and legislated in order to allow a business-like approach to Western energy investment.

A similar situation has arisen with the production associations (PAs), which are an essential part of energy projects as they have to be involved in the exporting of oil (gas is discussed below). In energy projects, the EBRD has been lending to PAs rather than fragile political institutions.⁶⁹ The PAs, however, have not been in a position to ensure foreign partners' ability to export oil; they are themselves restricted by federal government quotas.

The issue of export rights has been a major problem in the last few years, as the amount of oil being produced by Western-related joint enterprises has gradually increased. One of the factors which has led to the present difficulties is corruption, resorted to by Western oil firms, often as the only way to export all the oil to which they should have been entitled. It has been reported that corruption was so rife in the winter of 1991-92 that civil servants issued export licences for double the country's annual oil output. The capital flight through this dealing outside official channels is estimated at more than \$2bn p.a.. Another accusation levelled at many part-foreign JVs is that they abuse their export rights by also exporting other producers' oil, for a fee or percentage.⁷⁰ It is no accident that one of the government's first steps, in the winter of 1991-92, was to re-register all the export licences; many of the JVs set up under Gorbachev have been investigated, and have lost their right to export directly, now having to

⁶⁸ *Ibid.*

⁶⁹ *Petroleum Economist*, February 1993, and *Russian Petroleum Investor*, April 1992.

⁷⁰ *Kommersant*, no. 23, 14 June 1993.

export through a state-owned intermediary.⁷¹ In June of 1993, two thirds of oil producing joint enterprises which are more than 30% foreign-owned had their right to export their oil cancelled, whilst their activities were being examined.⁷²

Yet the reason behind the need for much of the malpractice and bribery is the lack of legislative clarity and control, and the complicated export mechanism. One disorientating factor in the exportability question was the applicability of the Russian Federation 'Law on Foreign Investment in the RSFSR', which specifies that any joint enterprise with more than 30% foreign-owned capital can export all of its production, with no written exemption for the oil and gas industry. In practice, however, this right was not guaranteed. Although the export quota of such JVs is their full production, export licences also had to be obtained (until the spring of 1994), for any volume up to that of the quota.⁷³ Licences were obtained monthly, varying arbitrarily from month to month, companies regularly obtaining no permission at all. In the case of Occidental Petroleum, on average less than half their export quota (which was less than full production, under the terms of their agreement) received licence for export in late 1992 and early 1993.⁷⁴ At the same time, as noted above, licences were being obtained by bodies not legally allowed to export oil.

As serious a deterrent to energy investment is the justifiable fear of not even reaching the production stage, despite exploratory work and the expenses it involves. As already noted, the right to prospect for and survey oil and gas is all that is normally granted to foreign oil companies in tenders for work on a field, production being the subject of subsequent agreement; this remained the case under the Law on the Subsurface.

The list of powerful disincentives unfortunately continues with the disastrous fiscal climate for energy investors who have not managed exemptions.

⁷¹ *The Financial Times*, 23 September 1992.

⁷² *Kommersant*''', no. 23, 14 June 1993.

⁷³ Postfactum in English, 8 January 1992, from *SWB*, Weekly Economic Report, Former Soviet Union, 10 January 1992, and interview with Boris S. Teremenko, Chairman of Quinta joint stock company, 1 June 1993.

⁷⁴ Interview with Robert Tornstrom, Head of Occidental Petroleum in Moscow, 18 March 1993.

The list of tax outgoings in the spring of 1993 was prohibitive: export tax of \$5 per barrel, subsurface resources royalty of 12%, subsurface resource replacement tax of 10%, an excise fee on domestic controlled price of 68¢ per barrel, as well as the corporate tax of 32%; this is on top of operating, transportation, original investment and reinvestment costs.⁷⁵ According to the highly-respected Petroleum Advisory Forum, using average investment and reinvestment costs, Western oil companies make a loss of \$2.67 per barrel at the then current price of \$16 per barrel; even at \$20 per barrel, there would be a loss of 13¢ per barrel under the present fiscal regime. One of the main criticisms is that all of these taxes apart from the corporate tax are on gross revenue, not on profit. Even the corporate tax is calculated on a profit figure which does not take into account the original investment nor a realistic deduction for reinvestment. One of the effects of this situation, as pointed out by Quest Energy, is that reinvestment is kept at unacceptably low levels.⁷⁶ According to Petroconsultants, even at a price of \$20 per barrel, production would have had to be of 100 m barrels to become profitable; for most producers, the price would have to reach an unrealistic \$30 per barrel for production to be profitable, unless taxes are lowered.⁷⁷ There was a positive sign in March 1993, when it was announced that all part-foreign joint enterprises could apply for exemption from the \$5/barrel export tax (previously it had been only JVs registered before 1 January 1992).⁷⁸ This by no means solves the problem, however, as even if the application for a waiver is approved, it has been reported that obtaining the necessary exemption papers at customs is impossible, and that even if everything is in order, reimbursement is so late and unsure that companies still have to count the money as lost. Clearly, the Russian government had a great deal to change if it was to create conditions favourable for EU oil and gas companies' large-scale investment.

⁷⁵ 'Russian Crude Oil Exports: Tax Analysis', Petroleum Advisory Forum document, February 1993.

⁷⁶ *Petroleum Economist*, March 1993.

⁷⁷ *Moskovskie novosti*, no.24, 13 June 1993.

⁷⁸ *Petroleum Economist*, April 1993.

Turning to concerns particular to the gas industry, Gazprom's continued monopoly has remained a great disincentive for foreign investors. Despite the developments in the oil industry, and pressure from potential foreign investors, leaders of the Russian gas industry have strongly supported a continued monopoly. At the International Seminar on Oil and Gas Legislation in October 1992, under the auspices of the EC, Vitalii Cherniak presented a draft law on gas which supported the existing strong central control, in order to avoid the chaos which had enveloped the oil industry.⁷⁹ From the Western point of view, however, the prospect of investing what often needs to be billion-dollar sums in an industry where only Gazprom controls exports is far from inviting, and many Russian PAs also resent Gazprom supremacy.⁸⁰ When the political situation is so uncertain, a state-controlled organ such as Gazprom is bound to be mistrusted; from the Western investor's perspective, an oil-type scenario for joint production and ownership, for all its failings, is still preferable to a Gazprom monopoly.

A2.5 Specific EU Involvement in the Sector

Despite the enormous difficulties involved in working in the Russian energy sector, West Europeans' interest in participation and potential profits remains extremely high. The sheer volume of the resources described in section (A2.1) is clearly the main reason, coupled with the vast demand for Western technology and capital, as described in section (A2.3).

Another aspect of the attractiveness of Russian oil and gas production is to ensure not so much that present contracts can be fulfilled, but to ensure that future demand can be satisfied at the lowest possible price. According to Jonathan Stern, demand for gas in Europe is expected to increase from its level of 370 bcm

⁷⁹ *Kommersant*'', 7 October 1992.

⁸⁰ Presentation by Jonathan Stern, at the 'Opening Up of the Post-Soviet Gas Industry', 15 April 1992.

in 1989 to 650 bcm in 2009.⁸¹ Without Russia, meeting such demand will be extremely difficult; Russian gas may well account for over a third of European consumption by then, given the right investment, and no EU gas company wants to be left out.

The prospect of so much of Europe's gas being provided by Russia will awaken in many the old fear of dependence. Ever since the 1920s, there have been fears of the Soviets using cheap oil to make foreign countries rely upon their energy, and then exploiting this as political leverage. Reliance did grow, with the decrease in world energy demand and increases in Soviet oil and gas exports in the early 1980s, when the EC's share of crude oil originating from the CMEA climbed to 8.5%. But Stern suggests that political use of energy supplies is not a realistic option for Russia *vis-à-vis* Western countries. Although the USSR has not been averse to using fuel power politics within the Eastern Bloc, and Russia has shown the same tendencies recently towards Estonia, Moscow has virtually never cut energy to Western or non-aligned countries. The reason is, as proved when supplies to Israel or Ghana were curtailed, that alternative sources are easily available. Oil supplies are intrinsically very mobile, and the gas transmission system in continental Europe is now so complex that talking of degrees of dependence of one particular importer is meaningless. Stern's study suggests that if anything, in the 1980s the USSR was more reliable in its oil and gas deliveries to non-CMEA and non-Third World countries than many of their competitors.⁸² The situation would of course be different if the rest of the world did not have enough energy to be an alternative supplier, but this situation is still very remote.

Paradoxically, one of the reasons now given to support greater energy trade between Western Europe and Russia is to provide an alternative to dependency upon another area — the Middle East. The European Parliament's Committee on Energy, Research and Technology reported their belief that 'given the looming

⁸¹ *The Financial Times*, 24 October 1990.

⁸² Jonathan P. Stern, 1987, *op. cit.*, pp. xi-1, 29-53.

concentration of oil supply in the Middle East, it is in the West's interest to prevent Soviet oil exports from declining'.⁸³

There is also an element of racing against time for EC energy entrepreneurs, in terms of beating other Western competitors to the best deals, both in extraction and in marketing of the product. The scenario is an ever-changing one. In Germany, for example, strains have appeared in the relationship between Gazprom and Ruhrgas, as Gazprom has been trying to sell directly to Ruhrgas' clients through its new German-based marketing agent, Wintershall. This is despite the fact that in the past Ruhrgas has traditionally shielded Russian exporters from financial risk and looked after sales, which have amounted to over \$20bn. Gazprom has been concentrating in the Eastern *Länder*, investing capital in the 'Verbundetz Gas AG', even considering an alternative gas transportation network. Yet new Russian gas, competing with other Russian gas owned by Ruhrgas, could become problematic and could destabilize the whole price structure of European gas.⁸⁴

To solve questions of access to markets and competitiveness in a new Europe, as well as very many other problems, the European Energy Charter was signed in December 1991 by all the countries of Europe, including the European Community, and nine of the twelve CIS states (the other three signed later, as did the Baltic states), as well as Australia, Canada, the USA and Japan. The problem of ensuring adequate supplies for future European energy needs was also part of the reasoning behind the Charter, as was the desire to secure alternatives to Persian Gulf oil. Other paths towards greater cooperation within an integrated European energy market proposed by the Charter include regulations ensuring an open market in fuels as well as in supportive capital and technology; promotion and protection of investment; coordination of energy policies and safety standards; improvement of energy efficiency and environment protection, and training programmes to achieve all these goals. In parallel to the Energy Charter,

⁸³ *European Parliament Session Documents*, 11 November 1991.

⁸⁴ *Russian Petroleum Investor*, April 1992.

a series of protocols is also being prepared, on nuclear energy, oil and gas, energy efficiency, clean coal, electricity, and new and renewable energy resources. One obvious problem, however, is the present discrepancy in regulations and standards of cleanliness and safety, to name but two; the delay in standardization will inevitably be very long.⁸⁵ The Charter is only a political commitment, and not legally binding; for this we must wait for the European Energy Charter Basic Agreement, which will only be signed after many fears of inability to compete or loss of sovereignty have been appeased. Many managers of the energy sector are suggesting that a crucial role for the Charter would be to run an investment protection fund for the sector.⁸⁶

With every wave of effort from Western governments to stabilize the situation in Russia, the pressure to ratify the Energy Charter Treaty, and make it work, has increased. In negotiations in October 1993, the Community was pursuing the following objectives: to set the highest possible levels of protection for investors; to maximize access to investments; to lay down strict provisions governing the freedom of transit; and to open up access to trade in energy materials and products. Russia's position at the October negotiations was that whilst it reaffirmed its attachment to the principle of national treatment for investments, it requested a three-year period of adjustment after the signature of the Basic Agreement in order to frame the legislation needed for the orderly implementation of the market economy system and, where necessary, to prepare a list of exceptions to that principle.

The Community's proposed solution to this request was to adopt a two-stage approach to the Basic Agreement. In the first stage of the Agreement, final agreement would be reached on all issues, except for the detailed procedures for implementing national treatment during the pre-investment stage. On this particular issue the MFN principle would apply for a period not exceeding three years. The second stage of of the Agreement, to be completed within that three

⁸⁵ Perdita Fraser, 1992, op. cit., pp. 39-41.

⁸⁶ *Petroleum Economist*, February 1993.

year period, would aim at full implementation of national treatment to the pre-investment stage. The Russian delegation welcomed this idea, although an official opinion was to follow closer study. Other general problems yet to be satisfactorily solved were whether equipment and services should be included in the Basic Agreement, the applicability of the rules of transit to the continental shelf, and temporary suspension of access to convertible currencies. Another major hurdle, this one not involving Russia, is that the USA and Japan were resolutely opposed to the Regional Economic Integration (REIO) clause; this clause proposes to protect the *acquis communautaire* and any developments thereof from being considered as national treatment enforceable by the Basic Agreement. Such an extension of the Community's rules would be unprecedented, with the exception of the EEA Treaty and the Europe Agreements. The REIO clause would cover the preferential agreements concluded in the EEA and Europe Agreements, and may be of interest to the CIS or other free trade areas yet to be established.⁸⁷ Whether because of American and Japanese objections to the REIO clause, or problems associated with granting a three-year 'transition' stage to Russia, at the time of writing the Basic Agreement was yet to be signed.

The largest credit-granting deals from the IBRD, the IFC and the EBRD have already been enumerated. Another possible boost to the energy sector from the Washington agencies could soon come in the form of credit for other CIS states to be able to buy Russian hydrocarbons at world prices, and this could also be a less controversial way of allocating some of the promised credits without the desired economic conditions having been achieved; at the IMF's Council of Directors' meeting in April 1993, however, this was still merely a suggestion.⁸⁸

EC assistance, though on a more modest financial scale, has also singled out energy as a priority. In both 1991 and 1992 TACIS programmes energy

⁸⁷ *Communication from the Commission — The European Energy Charter: Fresh Impetus from the European Community*, Commission of the European Communities' document, Brussels, 4 November 1993, pp. 2-5.

⁸⁸ *Eastern Bloc Energy*, April 1993.

accounted for more spending than any other area. In the 1991 programme, 115mECU were set aside for energy, with about half of it going to nuclear safety. The non-nuclear energy projects in TACIS 1991 were extremely varied, including, for example, ventures in reorganization and refurbishment of power plants and of power distribution, management training, pipeline design and installation, creating a *vade mecum* for foreign investors, consulting on tariff policy, as well as organizing well-attended conferences on energy legislation options. Direct production of oil and gas represented only a small fraction of the resources of know-how being directed at the sector as a whole; there was one project on gas injection engineering, one on horizontal well training, one on well drilling and oil production, and one on gas control and production; in total these four projects cost a relatively insignificant 1.8mECU. The reason is partly because the EC's expressed policy is to encourage maximal use of existing production rather than concentrating on increased extraction, and partly because the necessary capital for important production projects is far outside TACIS' means.⁸⁹ Desperately needed energy saving and efficiency had the most projects in this first year, Russia having at least 11 projects directly aimed at this weakness, the most important of which were two energy centres in Moscow and Saint Petersburg which accounted for over 5mECU. Showing that oil and gas would remain a priority in EC/EU assistance for some years to come, a part of the 1991 TACIS energy budget went to establishing a long-term Task Force in Tiumen'.⁹⁰

This created a solid base for TACIS 1992, which concentrated on four geographical areas, one of which was Tiumen'. Of the 12.5mECU allocated to Tiumen' (again in 1992 the lion's share of energy spending went on nuclear safety), about half is aimed at the oil and gas enterprises themselves, and the rest at sustaining balanced development in the area, in accordance with a Presidential decree to that effect. On the oil and gas side, the aim is to consult with productive

⁸⁹ Interview with Wolfgang Kaiser, Russian CU, op. cit.

⁹⁰ *Evropa*, March-April 1993, and 'Indicative List of Project. TACIS 1991 — Energy Sector', EC document, late 1991.

enterprises on desirable forms of organization and association, as well as to train management in business skills, fuel loss reduction, upgrading their technological basis, and in optimum methods of converting from state to private enterprise. To support the oil and gas industries in the area, the programme also includes ventures to assist agriculture, food distribution, financial organization and forestry.⁹¹

TACIS 1993, as well as continuing to fund the establishment of energy centres to encourage greater fuel-efficiency, included four main programmes concerning oil and gas. One of these is in the Urals regional Action Programme; it provides 2.8mECU to help with the conversion of a defence manufacturer in Ekaterinburg, facilitating the establishment of an oil equipment certification centre.⁹² The three projects under the federal Russian Action Programme amount to 8.4mECU. The largest of these aims to provide support for the Ministry of Fuel and Energy (Mintopenergo) in the formulation of policies more conducive to foreign investment in the industry, as well as with the restructuring of local oil companies. Mintopenergo is also the beneficiary for the next action, providing assistance with the logging and analysis of geophysical data, the development of new production technologies, and environmental protection systems. Finally, the 'Astrofizika' plants receive 2mECU to use their expertise in laser equipment to develop a capacity to produce equipment for the detection of pipeline leakage.⁹³ It would appear that the targetting of programmes, especially in 1993, has followed careful study of the main problems of the industry. Two of the main failings described in this appendix are addressed: low quality or lack of domestic equipment, and prohibitive and unpredictable legislation. The amounts being spent, if compared to the scale of the problem, are as minuscule as ever, yet if

⁹¹ 'TACIS 1992 — Action Programme — Tiumen'', European Commission document, October 1992.

⁹² 'TACIS 1993 — Action Programme — Urals', European Commission document, no date. p. 20.

⁹³ 'TACIS 1993 — Action Programme — Russian Federation', European Commission document, no date, pp. 75-77.

these projects are successful and become widely emulated, their effect could be very significant.

Although the EU is the most important provider of know-how programmes, other organizations are also playing their part. The UN, for example, has set up a scheme called Energy Efficiency 2000 to encourage the availability of Western energy-efficient technology in the FSU and Eastern Europe.⁹⁴ For its part the NYMEX commodity exchange is carrying out a \$800,000 project, co-financed by USAid, to translate materials about the energy futures market, to send professors to give courses in Russia, and to give practical experience to the best pupils in New York, all in the hope of developing a more up-to-date and efficient energy market in Russia.⁹⁵

These are all steps in the right direction, but the effect of technical assistance is never immediate, and not enough; all the know-how in the world cannot do much without the money and equipment to use the new knowledge profitably.

A2.6 Conclusions

It is clear that the scale of oil and gas resources in Russia, and the potential for EU involvement in its extraction, transportation and marketing, is enormous. It should not be forgotten by the Russians, however, that Russia is far from being the only new area in which energy enterprises might invest. There is stiff competition from the sixty other countries where oil is already being extracted, and even the forty-two where exploration is taking place; particularly interesting opportunities are arising in China, South Africa, India and Argentina. There are many more opportunities for investment going at the moment than there is free capital available.⁹⁶

⁹⁴ Perdita Fraser, op. cit., p. 39.

⁹⁵ *Moskovskie novosti*, no. 24, 13 June 1993.

⁹⁶ *Moskovskie novosti*, no. 24, 13 June 1993.

Nevertheless, despite the many factors making investment in Russia extremely high-risk, the amount of capital being committed by foreign energy enterprises in Russia has grown steadily. Even though in very many cases the taxation levels have meant that production could not possibly be profitable, Western companies have remained involved, partly to learn how to deal with the Russian oil or gas industry, and partly to be in the best possible position when profitability does become possible. The levels of investment still need to grow exponentially, however, if Russia's oil export volume is not to shrink further, and in order for gas production and delivery to grow with European demand. The degree to which this is allowed to happen, avoiding a delay of decades, is mostly up to the Russian leadership. Only very clear signs that Western investment is cherished, and will be helped and protected, can open the way for the needed level of capital inflow.

The Western side must also show its desire to assist, and an understanding of the inevitability of a degree of confusion in this period of transition. An increase in the flow of technical assistance is desirable, but most of all there is a need for many more large credit guarantee schemes, such as the \$2bn one recently offered by the USA's OPIC. Such examples of support and confidence in the Russian oil and gas industry should be emulated by other governments and multinational institutions. In this the EU, very possibly through the European Energy Charter, could usefully take the initiative, not least because of the likely European need for Russian gas in the next century.

TABLE A2.1: MAJOR JOINT OIL AND GAS PROJECTS IN RUSSIA

Western Partner(s)	Russian Partner(s)	Site of Project	West./Total Invest.	Type and Status of Project
ABB Lummus Crest	Lukoil	Krasnodar	? / \$1.5bn	Development of refinery.
ABB Lummus Crest/ Chevron	Kirishi refinery	110km from SPb	? / \$500m	Provide 'isocracking' tech. to refinery.
Agip (Italy)	Lukoil	East-Pridorozhnii	? / ?	Exploratory drilling.
Amoco/Exxon/Norsk- Hydro/Texaco	none	Timan Pechora	\$100m/\$100m	To explore 11 oilfields; pending govt. approval.
Anglo-Suisse/ Phibro Energy	Vareganneftegaz	Varegan	? / ?	In trouble due to high taxes; but largest producing JV in 1st 1/2 1994.
C. Itoh (Jap.)	Ufa oil refinery	Ufa	\$100m/\$100m	Agreed payback deal to increase refinery capacity.
Canadian Fracmaster/ Royal Dutch—Shell?		Iugansk	? / ?	3rd largest prod. in 1st 1/2 1994.
Dresser Inds. (USA)	Gazprom	St Petersburg	? / ?	Convert Kirovsky plant, to make compressor turbines.
ENI/Nuovo Pignone,...	Gazprom	through Russia	\$2bn contract	Funding of \$1.6bn by It. and UK banks.
Exxon/Sodeco	?	Sakhalin-1	? / \$10bn	Still negotiating in April 1994.
Marathon/McDermott/ Mitsubishi/Mitsui/Shell	not yet clear	Sakhalin-2	? / \$10bn (310m in 5 yrs)	Still negotiating in April 1994.

Western Partner(s)	Russian Partner(s)	Site of Project	West./Total Invest.	Type and Status of Project
Mitsui	Lukoil	?	\$700m / ?	Project to boost oil yields.
Occidental	Ukhtaneftegaseologia	Ukhta / Komi	\$3.5m / ?	Oxy has explored 5,000 km sq.
Syseca (Fr.)	Gazprom	whole Russia	\$135m contract	Set up computer control for pipeline.
Texaco	Sutorminskneft	W. Siberia	? / ?	Re-start drilling for low-sulphur oil.
Total (Fr.)	?	Komi	potentially \$1bn	Has pulled out, due to high local taxes and reserve overestimate.
Wintershall Gas	Gazprom	Iamal to Germany	? / \$40bn (in 25 yrs.)	Chosen to participate in building of planned Iamal-Evropa pipeline.

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